



**UNDERSTANDING CONSUMER CREDIT:
A NATIONAL SYMPOSIUM ON EXPANDING ACCESS,
INFORMING CHOICES, AND PROTECTING CONSUMERS**
SYMPOSIUM PROCEEDINGS
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**JOINT CENTER FOR HOUSING STUDIES
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INTRODUCTION

Over the past twenty years, consumer credit markets have been transformed with the rise of the subprime channel, an increase in the number of loan products and a general increase in the availability of credit. The structure and regulation of capital markets have also led to concerns that not enough care is taken to ensure that consumers are protected and fairly treated at the point of loan origination. These transformations, underscored by the recent turmoil in the subprime marketplace, were discussed in depth at the Joint Center's *Understanding Consumer Credit* Symposium. The Symposium examined the challenges of improving outcomes for consumers and driving market efficiencies in the consumer credit system while preserving the choice and access that borrowers with limited financial means and/or sub-par credit records now enjoy.

The Symposium was made up of seven panels on topics including: 1) consumer credit decisions, 2) the effects of capital markets, public information, and regulatory structure on the supply of credit, 3) consumer disclosures and product regulation 4) helping consumers make better decisions, 5) managing risks for the benefit of consumers, 6) protecting and empowering credit consumers in the OECD nations, and 7) implications (see *Appendix A: Symposium Agenda*). Paper presenters focused their presentations on the policy implications of their findings, and suggested how best to formulate a more cogent government response to credit challenges. Leaders from the business, government, advocacy, civic, and academic sectors responded to these findings and further explored their implications for business and public policy (see *Appendix B: Symposium Participants*).

The following proceedings are meant to capture the spirit and discourse that took place at the event. To begin, the proceedings attempt to capture a summary of the paper presentations in the order they were presented, followed by a summary of the lively discussion that took place throughout the event. The proceedings were not taped, and are therefore a distillation of notes and memory of the JCHS staff along with quotes and information directly from the papers. The Joint Center takes sole responsibility for the following content. Copies of the working papers are available online at the following web link:

http://www.jchs.harvard.edu/understanding_consumer_credit/ . In the next year, a portion of the papers will also be selected for publication by the JCHS and Brookings Institution and designed to communicate essential findings from the symposium to business and government leaders.

SUMMARY OF PAPER PRESENTATIONS

Overview Paper

Presenter: Eric Belsky, Joint Center for Housing Studies of Harvard University

Consumer and Mortgage Credit at a Crossroads: Preserving Expanded Access while Informing Choices and Protecting Consumers

Eric Belsky and Ren Essene (Joint Center for Housing Studies of Harvard University)

Aggregate debt-to-income and debt service ratios have surged over the last few years, meaning that consumers with debt have more debt and spend more of their income servicing this debt. However, while mortgage debt service ratios have grown, non-mortgage ratios have not. An important note is that access to debt has expanded most substantially among lower income households and seniors particularly auto loans, credit card debt and mortgages. As Americans' indebtedness is increasing, new mortgage foreclosures have reached record heights.

While broader access to credit lifts consumption and investment in leveraged assets like homes, credit terms and conditions govern the level of risk exposure for consumers. Failures in this system become quite costly for the individual, industry and taxpayers because foreclosures have significant negative externalities. While the new credit marketplace taps deeper into capital pools and spreads risk among investors, it also multiplies agency risk and reliance on third-party opinions. The current structure creates competition to control point-of-sale through broker commissions and has resulted in increased originations by non-deposit taking and less regulated institutions.

While consumers have a wider range of product choices, these are also more complicated credit choices and the potential for mispricing or unfair treatment is greater. The nature of imperfect information and the lack of pricing transparency coupled with the cognitive biases of consumer decision making has led to public policy concerns. The paper spells out many of the regulatory challenges, and explores eleven regulatory and legal levers including: strengthening examination and enforcement mechanisms, expanding public disclosures of lending activities, improving consumer lending disclosures, de-biasing consumers, prohibiting products, practices, rates, or contract terms, establishing broad suitability standards, imposing affirmative obligations to meet lending standards, expanding

standing to bring suits and stiffen sanctions, strengthening debtor remedies, weakening creditor remedies and imposing strict licensing standards and sanctions.

The paper also lays out ways to help consumers beyond regulatory interventions. Some ideas for helping consumers in trouble include; early identification and counseling/advice of borrowers in trouble shared with nonprofits and government, building more flexibility into servicing agreements and more proactive effort into workouts, and promoting alternatives to bankruptcy and foreclosure. Meanwhile, tailored financial education and literacy campaigns, better savings incentives and options and responsive insurance and debt protection products may help consumers stay out of trouble. Voluntary terms and pricing disclosures could also help consumers make more informed choices. Lastly, promoting development and licensing of third-party objective advisers, developing automated decision support tools for advisers and/or consumers, and making the default option the least risky product may steer consumers to better choices.

Panel 1: Consumer Credit Decisions

Moderator: Eldar Shafir, Princeton University

Presenters: Edna Sawady, Market Innovations Inc.

Shawn Cole, Harvard Business School

Paul Lubin, Informa Research Services

Discussants: John Campbell, Harvard University

Chuck Muckenfuss, Gibson, Dunn & Crutcher

Financial Decision Making Processes of Low-Income Individuals

Edna Sawady (Market Innovations Inc.) and Jennifer Tescher (Center for Financial Services Innovation)

The panel began with a presentation that examined the role of anthropological views of culture and cognition that help to reveal how cultural, social and experiential factors influence the decisions of consumers with shared experiences. The author's research efforts define a reasoning system that governs the financial decision making of low-income individuals, and then tests a series of product, marketing, delivery and service concepts that respond to those drivers. The paper uses ethnographic research techniques, including in depth interviews, focus groups and a survey tool, to infer a reasoning system which is based on interconnected core beliefs that guide decisions, cultural common sense, and consistency as a basis for rationality. The presenter

emphasized that the context of low-income individuals is relevant; poverty and its resulting unpredictability leads to a short-term focus, a history of exclusion leads to mistrust of mainstream practices, social networks through the community and family facilitate how individuals access resources, and the prevailing financial practices present an overwhelming range of options.

The authors constructed a range of service concepts that met the emotional and reasoning needs of the low-income interviewees who stressed their emotional need for belonging, respect, trust and achievement. The dimensions of reasoning, or common response patterns, became resource sharing, deliberate navigation where consumers choose simplicity and loyalty as a preference for long term relationships. From this construct, the authors demonstrated how financial service firms can acknowledge the emotions and typical responses of consumers to reach and serve them, from coaching to personal invitations to providing transportation. From the surveys, the authors found that these tactics were relevant across ethnicity and that tactics that addressed the emotional needs of respect and belonging ranked higher in importance than those that addressed more practical needs. Respect and navigation were of utmost importance, showing that they are central to the reasoning system of low-income consumers.

The implications that the authors highlighted is the need to move beyond “banking-the-unbanked” solutions that focus solely on price and convenience, such as reduced fees, bank branches and financial education. Instead, the authors stated that the emotional drivers of low-income consumers, such as a need for belonging and respect, need to be acknowledged and may be stronger than other economic drivers due to a history of poverty and exclusion. The framework presented provides insights for financial services firms in creating new tactics for reaching low-income consumers including changes to product features, delivery channels, branch operations and particularly the human resources of a lending institution. The authors stressed that the policy implications of the study include outcomes based measurement for CRA service tests and a focus on coaching over broad financial literacy. Further, the authors stressed that there remains a class of consumers that need protection because of their limited bargaining power.

Where does it go? Spending by the Financially Constrained

John Thompson (H&R Block), Peter Tufano and Shawn Cole (Harvard Business School)

The presenter began with a chart that showed the various tax return products that H & R Block clients' access across dimensions of time, sample size and the average refund. H & R offers a range of options from a Refund Anticipation Check (RAC) that takes 8-15 days to receive your tax return to the Instant Money Refund Anticipation Loan (IMAL) where a consumer can apply as early as October 15 and get their refund instantly against their future tax return. Beyond reviewing the transactions from the various refund options, the authors also explored data from the Emerald Card where 2 million clients receive their refunds. The Emerald Card allows the consumer to extract their refund through debits and ATMs as well as allowing the consumer to reload the card. The researchers were able to review the categories of spending on a transaction level basis but had limited information about the clients. They found that approximately 54 percent took out their refunds as cash and the balance was spent at merchants. Another 10 percent recharged their Emerald Card and used it as closed end debit card. Interestingly, 40 percent of customers had bank accounts, and 6-8 percent of the refunds went into a savings account.

One of the questions the authors asked was, "How long does the money last?" in an effort to understand consumers' urgency. Given that an account is considered "active" with a balance of greater than five dollars, they found that 54 percent of households still had active cards after one month. They did find that the spend down speed was correlated with the impatience seen in the product where the instant refund clients spent down their money more quickly than those who had waiting periods through the Refund Anticipation Loan and the Refund Anticipation Check. Overall the average life of the account was 68 days. The other question that the authors explored was, "What is the credit used for?" They found that the refunds were predominately spent on necessities, and that the more credit constrained consumers spent an even greater share on necessities than the less credit constrained.

Fair Lending Testing: Best Practices, Trends & Training

Paul Lubin (Informa Research Services)

The presenter reviewed the role of self-testing by lenders to monitor the sales and service practices and ensure compliance with legal and regulatory guidelines. Self testing is a good way to evaluate the actual treatment and experience of consumers. The presenter began by reviewing the role of pre-application testing in determining whether the consumer's ability to pay is considered and whether product steering, income/credit skepticism, omission of costs and fees and other behaviors existed in the transaction. Post-application surveys can uncover differences in assistance, detect whether access to credit information is sufficient and differs for protected classes, and measure the extent of coaching and disclosure. The author points out that these surveys are a good tool for assessing targeting of protected classes and whether the consumer's needs and ability to pay were assessed.

The presenter gave the example that whites were more often engaged in conversation and asked general questions first that put the consumer at ease, whereas minorities were often asked for their social security number, credit score and other personal information first which could be seen as a deterrent. Reviewing the most common self-testing findings, the presenter showed how practices have changed over time. He documented the dramatic changes in the marketplace from the 90's to the present including an increase in flexible underwriting, product choices, new delivery channels, reduced time, aggressive sales practices and an increase in ancillary products. He concluded that overt and subtle disparate treatment improved from the early to the late 90s but is now increasing in the 00s. Differences in product discussion and approval times, as well as credit insurance confusion, remain and testing showed that third parties (non-employees) are more likely to engage in disparate practices.

The author pointed to the fact that economists may think about how repeated interactions and the pressures of competitive business costs and practices can drive efficiency. Yet with repeated interaction, the presenter argued, culture can act as a medium for assuring that favors are returned. The presenter also explained that while there is a drive for efficiency, the dilemma is that consumers still want direct human contact which is very expensive to provide.

The presenter then discussed the best practices and remedies that have evolved from the 90s including self testing, file reviews, HMDA examinations, examination of underwriting standards, compliance reports, checklists, and neutral compensation. In the 00s, best practices

have included more sales training, clear standards and third party compliance monitoring. The author concluded that self testing can help to prevent misleading sales practices and disparate treatment, and that pro-active self-assessments and monitoring is needed to ensure that consumers are provided accurate and sufficient information.

Panel 2: The Effects of Capital Markets, Public Information, and Regulatory Structure on the Supply of Credit

Moderator: Ellen Seidman, ShoreBank Corporation

Presenters: Patricia McCoy, University of Connecticut

Richard K. Green, The George Washington University

Howell E. Jackson, Harvard Law School

Discussants: Steve Joseph, Sandler O'Neill and Partners

Daniel Bergstresser, Harvard Business School

The Legal Infrastructure of Subprime and Nontraditional Home Mortgages

Elizabeth Renuart (National Consumer Law Center) and Patricia McCoy (University of Connecticut)

The presenter reviewed the regulatory paradigms that have existed over time beginning with traditional usury caps on interest rates which were abolished by the DIDMCA (1980) while AMTPA (1982) authorized interest-only and negative amortization mortgages when the market was predominately a prime market. Disclosure laws were enacted through the Truth In Lending Act of 1968 and continue today, while regulation of non-interest terms and lending practices are more recent, including the Home Ownership and Equity Protection Act (2004) and development of state mini-HOEPA laws. Meanwhile, licensing and supervision of mortgage actors takes place in a patchwork fashion, given the range of regulators and regulations.

The presenter began by describing the two types of mortgages that exist, prime and subprime and suggested that the story is one of dual regulation and government failure. The presenter pointed to the preemption ruling of OTS and the OCC that have reduced the regulatory requirements on a range of lenders while allowing for an explosive growth of nontraditional mortgages. In this era of deregulation, charter competition has fueled the race to the bottom and erased substantive law protections. The authors point to the migration to national bank charters as an effort to flee state regulation, while lax regulation of nonbank mortgage lending

subsidiaries and conflicting mandates of federal banking regulators has created a vacuum of private remedies for borrowers.

Imperfect Information and the Housing Finance Crisis

Edward Golding (Freddie Mac), Richard K. Green (The George Washington University), and Douglas A. McManus (Freddie Mac)

The presenter began by pointing out that asymmetries in the marketplace have created market failures, while the drive for market share has also created a “lemons problem” for lenders. The presenter went on to state that there is clearly an information asymmetry between the borrower and lender, as the borrower is less knowledgeable about the product and implications of the transaction. Regulatory asymmetries also exist through the disparity in capital requirements, where the prime market has strict capital requirements yet the lack of capital requirements in the subprime market creates a lack of protection for call options. This drives the prime market to not like risk, whereas the subprime market has a big upside and small downside for taking huge risks.

The paper documents how subprime loans are more concentrated in the lower credit score categories, with a median FICO scores ranging from 618 for subprime, 647 for government insured and 733 for prime conventional, according to LoanPerformance data. Often borrowers, including investors, may not qualify for loans and they therefore use no/low documentation loans to get around the credit policies of lenders. The paper also illustrates that the share of no/low documentation loans for subprime home-purchase originations are higher with investor properties and second homes, as these same owner occupied loan types have decreased from 44 percent in 2003 to 32.4 percent in 2006.

Further, the paper shows that regulated institutions originate fewer loans with controversial features than unregulated institutions, with the share of low/no doc at 28 percent for regulated and 42 percent for unregulated and 2-year hybrid share at 38 percent for regulated and 49 percent for unregulated. The presenter’s takeaway was that everyone should have “skin in the game”, with the borrower having a financial stake in the transaction and the mortgage broker having their compensation tied to the performance of their loans. He argued that improvements must be made to create more transparency in the marketplace through the

adoption of public disclosures in the securities market. Further, the presenter believes that the creation of one regulatory regime is critical.

Enlisting Market Mechanisms to Police the Origination of Home Mortgages

Howell Jackson (Harvard Law School)

The presenter asserted that recent investors in the subprime mortgage market paid too much for their current assets, while borrowers paid too much for their origination services. The presenter explored the secondary market pricing mechanism as a potentially attractive mechanism for policing consumer abuses in loan originations given the market failures that currently exist. Given that mortgages have become a form of commodity with an ascertainable market price, the presenter argued for a better set of securities laws. These laws include mark-up rules and duties of best execution that both govern the extent to which securities firms can mark up the price of securities, and impose obligations on the firms. The presenter suggested that loan originators should be required to keep contemporaneous records of the market value of all originations to determine the mark up and originators should establish procedures to represent that the origination is the most advantageous for the borrower. Based on lessons from the securities industry, the author argued that this would also help regulatory officials focus their supervisory efforts.

The presenter argued that the American bank has been broken up into specialized firms, and the paper provides a flow chart that explains this mortgage loan origination process and points to the redundant and overlapping direct charges on borrowers. Beyond the perverse incentives for loan originators to exploit less sophisticated borrowers, the author describes in more detail how a duty of best execution could be incorporated to improve the point of sale transaction. The author classifies this specialized class of agency problems as a “trilateral dilemma of financial regulation” and proposes an aggregate disclosure strategy to evaluate firm performance. The presenter also argued for expanding the GSEs to participate in the subprime market.

Panel 3: Consumer Disclosures and Product Regulation

Moderator: Elizabeth Warren, Harvard Law School

Presenters: Mike Staten, The George Washington University

Anthony Pennington-Cross, Marquette University

Thomas A. Durkin, Federal Reserve Board of Governors

Discussants: Elizabeth Renuart, National Consumer Law Center

John Sepulveda, National Association of Mortgage Brokers

The Impact of Credit Price and Term Regulations on Credit Supply

Mike Staten (The George Washington University)

The presenter began by stating that rate ceilings can reduce supply, and asked if credit markets are different. Arguing that borrowers are readily distinguishable by the costs they impose on lenders, the presenter asserted that a restrictive rate ceiling reduces supply to higher-cost borrowers and that any regulation that raises the costs of serving higher-cost borrowers (e.g., limits on collection practices/late fees; limits on contract features developed for higher-risk borrowers) rations out higher risk borrowers first. The presenter argued that rate ceilings are not needed to hold down loan prices, as competition trumps ceilings and that restrictive ceilings result in higher charges at unregulated margins that are most harmful to higher-risk borrowers. Citing evidence from a State Laboratories study from 1971 that reviewed 36 month bank loans for new autos, the author argues that regardless of the rate ceilings imposed the average APR remained constant and therefore rate ceilings are self-defeating. In the paper, the author also discusses the history of rate ceilings and provides empirical evidence on the impact of rate ceilings from a multitude of studies.

The presenter pointed to supply and demand, where some regulations can boost demand while the net effect on borrowers and credit usage depends on how much they also reduce supply. Based on this observation, predatory lending laws tied to loan-price thresholds may single out higher-risk borrowers and make them even more costly to serve and places supply reduction squarely on the borrowers the law was intended to help. The presenter argued for policy changes that harness market incentives such as encouraging the entry of new competitors, allowing lenders to set price according to borrower risk, establishing streamlined and decision-

relevant disclosures that allow consumers to comparison shop, and letting competition impose pricing discipline on lenders. Lastly, the presenter argued that loan interest rate ceilings are a blunt instrument that restricts a large segment of the market.

The Impact of Predatory Lending Laws: Policy Implications and Insights

Anthony Pennington Cross (Marquette University), Raphael Bostic (University of Southern California), Kathleen Engel (Cleveland State University), Patricia McCoy (University of Connecticut), Susan Wachter (University of Pennsylvania)

The presenter reported on a paper that studies whether state-level predatory mortgage lending laws materially impact subprime lending markets and if so, asks the question of how a predatory lending law should be designed based on legal review, a comprehensive canvas of laws and a state border sample from HMDA data. From these data, the presenter summarized the three indices that were developed including a coverage index, a restrictions index and an enforcement index. The coverage index, including such variables as loan type and APR triggers, revealed a counterintuitive finding: broader coverage attracts new loan applicants instead of hindering their access to credit. Broader coverage impacted the odds of originating a subprime loan by +7 to +9 percent, being rejected on a subprime application by -13 to -15 percent, and had no consistent significant impact on applications. Tighter restrictions, or the strength of the law's restrictions on certain practices, impacted the odds of originating by -5 percent to -8 percent, being rejected by +13 percent to +18 percent and had no consistent significant impact on applications. Stronger enforcement mechanisms, such as borrowers having access to private legal redress as opposed to just governments, reduced the odds of being rejected on a subprime application by -4 percent to -5 percent and also had no consistent impact on applications or originations. The presenter concluded that when designing state predatory laws it is possible to increase the flow of high cost credit through coverage, reduce the flow through restrictions and have no impact on the flow through a typical law.

The presenter argued that anti-predatory lending laws therefore do impact subprime lending activity and that laws can be designed to restrict unsuitable loans while preserving or even increasing the vitality of the subprime mortgage market. The state by state analysis shows that compared to a typical state with no predatory lending laws, Minnesota had strong coverage, North Carolina had strong restrictions, Ohio had strong enforcement and Georgia had strong

restrictions and enforcement. The big surprise to the authors was that assignee liability & enforcement mechanisms have only a modest impact on market outcomes. The presenter also cautioned against passing weak laws that may give consumers false confidence and recommended that legislators look to mix Minnesota and Georgia laws for best effect.

Should Consumer Credit Disclosures Be Updated?

Thomas Durkin (Federal Reserve Board)

The author gave an historical account of the role of consumer disclosures in lending through such acts as the Truth in Lending (TIL) Act. The goal of disclosures has been to reduce the cost of information in the market based on the economics of information, where information is not free and is therefore insufficiently supplied, while market competition can be enhanced by inexpensive information. This theory encouraged disclosures in many areas beyond TIL, including the truth in packaging and use of disclosures for insulation ratings. The presenter reflected that TILA grew by accretion from only 3½ pages in 1960, devised by Professor Paul Douglas, to over 55 small type pages. Typically when a problem was identified, a disclosure was added. One of the persistent challenges with TIL is the ubiquitous APR calculation because APR is not a credit cost but a summary construct equating cash flows to present value, yet credit costs can actually be calculated many ways. While everything is possibly useful for something and there are many reasons for the growth of disclosures, there appears to be no agreement on the goals.

The presenter believes that the fundamental issue is “what is a credit cost?” Other challenges abound, whether dividing transactions into components, defining that not all outlays are credit costs, or determining unknown future events. These questions have led to a greater level of disclosure. This raises the issue: how much disclosure is enough? The presenter argued that these challenges persist because the goals of disclosures are not carefully specified. While disclosures may improve individual behavior, it is ideologically different than the philosophical goals of general consumer education or an argument that more information is better. The presenter argued that the survey evidence that shows that TIL has had an impact is that consumers are most interested in cost information and that a sizeable portion does shop for rates. He pointed out that credit shopping varies by the credit use and that consumers often shop by percentage rates. Further, the presenter argued that TIL disclosures have probably increased market competition, and

that the lack of universality does not indicate a failure of the TIL. While there are current proposals that call for more disclosures, the presenter asked is there some room for a new approach? Another possible approach that the presenter raised was interactive disclosures.

Panel 4: Helping Consumers Make Better Choices

Moderator: Joe Belew, Consumer Bankers Association

Presenters: Annamaria Lusardi, Dartmouth College and National Bureau of Economic Research
Michael Barr, University of Michigan

Bill Apgar, Joint Center for Housing Studies of Harvard University

Discussants: Keith Ernst, Center for Responsible Lending

Kevin Rhein, Wells Fargo Financial

Financial Literacy: An Essential Tool for Informed Consumer Choice?

Annamaria Lusardi (Dartmouth)

The presenter began by discussing how national surveys show that financial illiteracy is widespread in the population and acute among specific segments of the population: Women, the elderly, those with low education, and minorities. The presenter argued that financial literacy matters for financial decision-making, as those who are less literate are more likely to make mistakes. Acknowledging that the evidence is mixed and that it is difficult to measure the effects of financial education, the author pointed to several papers that find an effect of financial education programs, but stated that current financial education programs may simply be inadequate to address the widespread illiteracy.

The presenter argued that national standards for literacy need to be established, and that there may also be a role for requiring education such as a “financial driving license”. Policy recommendations that the presenter mentioned included providing incentives, simplifying information, providing expert information and simplifying decision-making. The presenter pointed to the UK where children have a savings account starting at birth set up by the government. The author also presented a savings pyramid, much like the food pyramid, that provides for simple steps that consumers can take. From the bottom tier of avoiding high interest rate debt, exploiting the power of compounding interest and taking advantage of tax incentives and employer’s matches, to a top tier of making your money last and avoiding “too good” deals.

The presenter stated that if a loan is not a 30-year fixed rate, the consumer has to go through some hassle to understand the financial details of the loan. Pointing to the concept of information debiasing, the presenter suggested that institutions could be required to disclose the wholesale rate at the time of the loan. Another path suggested was to innovate away from TILA and disclosure policies that have not proven to be effective.

Behaviorally Informed Home Mortgage Credit Regulation

Michael Barr (University of Michigan), Sendhil Mullainathan (Harvard University), and Eldar Shafir (Princeton University)

This paper explored the interaction between individual psychology and market competition, based on an economic framework in which outcomes are an equilibrium interaction between individuals with specific psychologies and firms that respond to those psychologies within specific markets.

In describing the firm and the individual in the credit transaction, the presenter described the market along two dimensions. The first dimension is when the market is neutral and desires to overcome consumer fallibility because the dominant market participants' interests align reasonably well with efforts to guide individual choice. Examples included consumers' misunderstanding of the value of compounding savings or procrastinating signing up for EITC and a lender or tax filing company has a self interest in reducing these fallibilities to increase the institutions savings base and increase its number of customers. In these cases, individual behavioral interventions may work well. The second dimension is the market exploiting consumer fallibility, such as consumers misunderstanding of compounding in borrowing where a lender would exploit this tendency to increase their lending or when consumers procrastinate in returning rebates, retailers exploit this tendency so as to increase revenues. The presenter suggested that individual-focused behavioral reforms may not work well in contexts where the dominant market players benefit when individuals act contrary to the direction suggested by the behavioral intervention.

The presenter suggested that behaviorally informed regulation could therefore benefit from considering the role of market responses to the proposed interventions. The presenter argued that given the diverse behaviors of individuals outside standard theorizing and a diverse set of market responses from firms, changes to the rules of the game are needed, both

psychological in nature and not. The presenter gave examples of policy and regulatory approaches in a 2x2 chart. Where the market is neutral, the presenter argued that public education on saving, encouraging direct deposit or auto-save, or licensing could be effective. Where the market exploits consumers, new rules could include sticky defaults (e.g. an opt-out mortgage product) or information debiasing on debt where the incentives between consumers and lenders are not well aligned. Some solutions discussed included: an ex-post standards based disclosure requirement, mandatory rate sheet pricing provided to the borrower, opt-out mortgage products, broker fiduciary duties, and/or banning yield spread premiums.

Helping Consumers Make Better Mortgage Choices

Bill Apgar and Ren Essene (Joint Center for Housing Studies of Harvard University)

The presenter argued that behavioral economic analysis and market research suggests that consumers often make choices that may not be in their best interests and that they may later regret, and consumers often fail to obtain loans that they understand and are able to repay. Specifically, marketing efforts often exploit consumer decision making weaknesses as some mortgage brokers, retail loan officers, and lending organizations use their knowledge of consumer decision making tendencies to aggressively market specific mortgage products. The presenter pointed out that targeted incentives encourage mortgage brokers and loan officers to push consumers to select specific and often higher-priced mortgage products. This destructive competition is furthered by the lack of uniformity in the regulation of mortgage market participants which distorts the market and is inherently unfair to consumers.

The presenter acknowledged that helping borrowers to make better mortgage choices must move beyond consumer counseling and education alone, and towards a system where consumers receive loan level advice and direction. One delivery system for this unbiased and individual advice is a trusted advisor network where mortgage brokers operate under specific guidelines for a transparent fixed-fee, helping consumers to qualify for an array of mortgage products. This network reduces incentives to push market particular mortgage products and encourages mortgage advisors to compete by offering superior customer service and higher quality. Selling the concept of “fairness” offers network participants marketing and fundraising advantages, and in doing so enhances their ability to compete with higher-cost and traditional incentive driven mortgage brokers and loan officers.

Existing non-profit mortgage brokerage operations seek to serve customers in a fair and unbiased manner, but generally these efforts work in isolation from one another and struggle to find a niche in the market that is consistent with a sustainable business model. The Fair Mortgage Collaborative seeks to establish a common national platform through which organizations can originate mortgage loans following consumer friendly principles, but to date has a limited membership. Mortgage Grader embeds a flat fee concept in a highly automated loan origination platform, but has yet to attract significant consumer appeal. Growing these operations to scale has proven elusive, and achieving scale will require the development of institutional supports. The history of other trusted advisor networks (e.g. Consumer Reports, Underwriters Laboratories, Good Housekeeping Seal of Approval) demonstrates that it takes both time and significant resources to create the brand awareness needed to break from past practices and have a meaningful impact on consumer behavior. The creation of new and technologically sophisticated tools (e.g. on-line mortgage pricing guides) can lower the costs of providing detailed advice on available products and pricing, and expand the capacity of a trusted advisor network to serve a wider range of borrowers. For a trusted advisor network to flourish, regulations must limit the ability of competitors to continue to deploy deceptive practices that enable them to push consumers toward accepting inappropriate and often higher-priced products.

Panel 5: Managing Risks for the Benefit of Consumers

Moderator: Ken Wade, NeighborWorks America

Presenters: Peter Tufano, Harvard Business School

Susan J. Smith, Durham University

Amy Crews Cutts, Freddie Mac

Discussants: George McCarthy, Ford Foundation

Karen Pence, Federal Reserve Board of Governors

Using Financial Innovation to Support Savers: From Coercion to Excitement

Peter Tufano (Harvard Business School) and Daniel Schneider (Princeton University)

The presenter discussed using private savings as a buffer for the poor. There are many savings options for government, the private sector and NGOs to implement, and this variety can better respond to the heterogeneity in savers' goals, settings, and behavior and the heterogeneity of partners' goals and resources. The presenter pointed out that these savings solutions differ by the degree of saver decision making, the perceived barriers to saving that must be surmounted, and the savings partner involved and its economics. There are many ways to support families including; forcing them to save as we have with social security or the U.K Child Trust Fund, making it hard for them not to save such as 401(k) defaults, making it easy for them to save such as tax time savings, bribing them to save such as IDA accounts, social support for savings such as Rotating Savings and Credit Associations (ROSCAs) and making them excited to save with prize linked savings.

The presenter discussed several of these examples. To make it easier to save, helping consumers to “buy” savings by changing the time and place to save may makes sense. Yet when a consumer is borrowing money at a 20 percent interest rate, it may be difficult for them to set aside savings at a 2 percent interest rate. One way to excite savings began in 1694 when the British Government offered a “Million Adventure”, providing lottery linked savings. The UK continues to offer such premium based programs, yet US banking and state laws make it illegal in the US. Indiana found that lottery players typically have no savings plan, no savings but remain very optimistic. Given that \$50 billion is spent on the lottery and \$1.1 trillion on the gaming industry, the presenter argued that diverting some of these expenditures towards savings may make good sense. Picking the intervention raises a host of questions including, *what*

impediment is most salient? what distribution channels reach the saver? what resources will the savings partner contribute? and what type of saving are we trying to support? The presenter concluded by saying that many avenues are possible and researching the impact on total savings will be important.

Identifying, Managing and Mitigating Risks to Borrowers in Changing Mortgage and Consumer Credit Markets

Eric Belsky (Joint Center for Housing Studies of Harvard University), Karl E. Case (Wellesley College) and Susan Smith (Durham University)

The presenter discussed a study that explored the management and mitigation of risks facing consumers with mortgages and discussed trends in housing wealth, risks associated with debt both systemic and individual, and ways to mitigate those risks. The systemic risks include payment reset risk from rising interest rates, income shocks and investment risks. Individuals may also face risks from unforeseen events that shock their budgets, and insuring against these kinds of risk is exceptionally difficult because of the possibility of rent-seeking behavior or adverse selection. Traditional methods for managing lending risk in the US include consumer credit insurance and debt cancellation products, while the UK has a complex array of loan payment protection insurances. These products “insure” the borrower as well as the lender by preserving borrowers’ credit scores and reducing future borrowing costs. The presenter pointed out that these products are convenient to sign up for as they are offered at the point of sale and the vast majority of consumers that have it express satisfaction.

The presenter reviewed the ongoing concerns that are leveled at these products including the pressure on consumers to purchase irrespective of ‘need’, the way the lender selects the bundle of coverage, and the inadequate federal and state oversight and enforcement. A principal charge is the high cost of origination and administration compared to a low “loss ratio.” In a product realm where consumers do not shop but are offered specific products, another concern is “reverse competition” where insurance companies compete for the business of lenders through high compensation instead of competing for borrowers based on low prices. Lastly, some fault the industry for the practice of “look-back underwriting”, where eligibility is checked only after a claim is filed.

The presenter focused the rest of her talk on a discussion on derivatives, “Contracts which effectively separate the investment returns on commodities, assets and securities from their ownership and use.” The value of these financial instruments comes from the price of the underlying asset or index yet they can be traded independently. Housing derivatives separate out the cost of the homes people own, occupy and use (H) and the cost of the investment vehicle (P) or the ups and downs of price. Therefore, the presenter pointed out that investors could buy into the performance of a basket of house prices and could potentially reduce the cost of entry to homeownership by as much as 25 percent. Basically, the buyers are selling the property appreciation in return for lower levels of debt. The presenter argued that they are a means of transferring or managing market risk as well as an investment opportunity. While these instruments are typically used by large institutions to diversify risk, in principle they could be packaged into products designed to protect the consumer. The author quoted Quigley who cited that derivatives are the way “to improve the welfare of European housing consumers at practically no cost”.

**Interventions in Mortgage Default:
Policies and Practices to Prevent Home Loss and Lower Costs**

Amy Crews Cutts and Bill Merrill (Freddie Mac)

The presenter discussed how many borrowers do not know how to handle a mortgage problem. Often, borrowers do not know who to call or what can be done to help them, thus missing an opportunity to avoid foreclosure. Clearly, effective default counseling services are the next frontier. The presenter reminded the audience that early intervention is critical: the longer the delinquency, the harder it is to recover and the greater the losses are for all parties involved. Foreclosure is not good for anyone as the process is lengthy, it reduces the incentives to the borrower to reinstate the loan and increase the losses for investors. Finding ways to align the incentives is important because the borrower wants to keep their home, the servicer wants to make money and keep costs low, and the investor wants the loan paid as agreed.

Reviewing Freddie Mac loans that have entered repayment plans between 2000 and 2006, the presenter reported that early intervention is critical. The ability to cure a loan with a repayment plan is higher when the delinquency problem is smaller. Further, using data from a sample of recent Freddie Mac property dispositions, the presenter shared that most pre-foreclosure costs are time-sensitive and are related to costs of homeownership while most post-

foreclosure REO costs relate to property condition and local housing markets. Lastly, the presenter investigated the share of loans that cure out of foreclosure by the state statutory foreclosure timelines. They concluded that some states could reduce investor costs, and improve the likelihood that borrowers will cure out of foreclosure, by shortening the statutory timelines to near national median timeline.

Panel 6: Protecting and Empowering Credit Consumers in the OECD Nations

Moderator: Katherine McKee, Consultative Group to Assist the Poor

Presenters: Elaine Kempson, University of Bristol
Gunnar Trumbull, Harvard Business School

Discussants: Duncan Kennedy, Harvard Law School
David Porteous, Bankable Frontier Associates

Looking Beyond Our Shores: Consumer Protection Regulation Lessons from the UK

Elaine Kempson (University of Bristol)

While secured and unsecured lending in the UK is fairly similar to the US, the regulatory structure differs. The presenter discussed the UK's self-regulatory Mortgage Code and explained that in 2004, a new regulatory body was formed to regulate all prime and subprime lenders and brokers of mortgage loans. The author noted that the development of the new Financial Services Authority (FSA) was supported by both consumer groups and the mortgage lenders trade association. In reflection of some of the issues raised at the Symposium, the presenter pointed out how the UK addressed some of the issues we grapple with in the US. The FSA has a comprehensive *Conduct of Business Rules* and high levels of risk-based supervision and consumer protection that cover a host of issues including sale and advice standards where the advice must be suitable for the consumer. In addition, UK lenders must also consider affordability at the time of payment resets. In the UK, foreclosure is seen as a last resort only used when all reasonable attempts have been made, and lenders have a host of policies to help borrowers that are in arrears including detailed payment plans.

The FSA's risk-based approach to supervision of all firms includes both assessing the risk of individual firms and thematic reviews. These reviews include the use of file reviews, mystery shoppers and shadow shopping, where real consumers are followed. There is also a

Financial Ombudsman Service that handles all complaints to determine what is fair and reasonable given the circumstances of each case to resolve individual disputes through mediation and adjudication. They have received over 627 thousand enquiries, half of which were endowment mortgages, and of the 94 thousand new cases, three quarters came directly from consumers. Outside review of the Service has concluded that the Service operates ‘fairly, reasonable, quickly and informally’ decisions are reasonable and the services are high quality and consumer credit has been included since 2007.

On the unsecured consumer credit side, there is an Office of Fair Trading that issues credit licenses and oversees a new ‘unfair relationship’ test. Supervision of compliance is executed through the *Banking Code and the Finance and Leasing Association Lending Code*, which are currently outside the FSA. The presenter admitted that there is weak supervision of unsecured credit, and that the codes cover most but not all of the market with variable supervision of compliance.

The author writes, “Self-regulation has played an important role in providing full consumer protection in areas of responsible lending and dealing with customers in financial difficulty” through the FSA conduct of business rules. Self regulation has been able to respond quickly to abuses and has driven up standards across the industry. Yet, unsecured lending does not fall under this regime and has more of a patchwork of regulations. The presenter pointed to the possible need for CRA-like legislation, as the question of access to affordable credit continues to be raised. The presenter also noted that provider regulation works and self regulation can work, but industry has to want this form of regulation and supervision and compliance monitoring is essential.

Consumer Protection in French and British Credit Markets

Gunnar Trumbull (Harvard Business School)

The presenter pointed out that as many countries have seen stagnation or even falling real wages and therefore a rapid growth in over-indebted consumers, national governments have revised their policies for protecting borrowers. Both France and Germany have experienced dramatic growth in borrowing, while the US and UK indebtedness continues to grow as well. The presenter mentioned that in 2007, indebtedness stands at 68% of disposable income for the French and 166% for UK households and difficulties in repayment are growing as well. While

there is a relationship between indebtedness and insolvency, the growth of insolvency in France and the US has increased more sharply than in the UK or Germany.

The presenter's paper reviewed the consumer credit reforms in France and the UK and focused on three subjects for comparison: measures to promote transparency and limit exploitation, regulation of credit rating agencies and bankruptcy reform efforts. As the presenter states in his paper, while the structure of consumer lending in both countries is quite similar, the history and philosophy's are different. In some ways, the countries are similar such as the structure of state financed medical systems. In other areas they differ: France has a tradition of inexpensive access to savings, while the UK deregulated consumer lending early. In a recent survey, the presenter pointed out, France ranked uniformly high in consumer protection while the UK ranked low in all but one category. Interestingly, the presenter noted that while the British policy makers see consumer credit as a tool for fighting social and economic exclusion, the French perceive that it risks aggravating this exclusion.

In terms of data on borrowers, the presenter stated that France's credit rating system records only negative credit episodes, like late payments, and has become a no-credit black list for borrowers.

In the UK, private databases of consumer data are held by credit reference agencies like Equifax who provide the raw data to lenders. While France has liberalized their lending in some regards, they have also strongly sought to maintain consumer privacy, with concerns about creating a permanent group of social and economic outsiders. Yet, there concern could become a self fulfilling prophecy where ending up on the blacklist traps the borrower in high cost borrowing.

While both the UK and France have bankruptcy laws and negotiated approaches to remediation, there is significantly greater household indebtedness in the UK yet more French borrowers enter insolvency proceedings. The presenter offered several reasons, from the availability of positive credit ratings in the UK that may have allowed for more fairly priced credit, or the French bankruptcy process could set a lower bar of entry or carry fewer stigmas for the consumer. Whatever the case, proceedings are triggered by similar household issues such as unemployment, business failure (UK), accidents and illness, excessive borrowing (UK) and divorce (France).

In summary, the presenter pointed out that as both countries have experienced a growth in consumer indebtedness they have followed the US and made it easier to discharge debt and

engage in voluntary contract renegotiation while France has maintained a deep concern about contract sovereignty. More interesting is what makes the nations different. The UK's focus on improving credit access for the poor to promote entrepreneurship and therefore overcome social and economic exclusion and reduce the limits on risky innovation. In contrast, the author points out that the French policy has focused their concern on the risk of exclusion from the benefits of citizenship for victims of excessive debt, and the concern about the transfer of wealth from the poor to the rich through credit contracts. This concern dovetails with the country's commitment to equality, and their concept of inclusion is expressed through government and labor policies rather than access to credit. The presenter ended with a question: whether a common regulatory regime in Europe would prevail or whether these divergences would persist.

SYMPOSIUM DISCUSSION

Over the course of the two-day symposium, a rich discussion took place around the conference themes and issues. The symposium was rooted in two overarching premises that shaped the debates and discussions:

1. That consumer and mortgage credit markets have evolved in ways that have created unintended consequences and challenged industry, lawmakers, regulators and community groups alike.
2. That, for all involved, the central challenge is balancing expanded access to credit with consumer protections and safety and soundness of the financial sector.

While auto loan, credit cards, student loans, and other installment loans were discussed, much of the conversation steered towards mortgage credit. Given the timing of the symposium, it was perhaps inevitable that a great deal of time was spent debating the origins of the problems roiling the mortgage credit markets in the second half of 2007 and what to do about them. Allowing the conversation to follow its own course resulted in returning again and again to the two central premises of the conference. One discussant suggested that, as a result of problems in the mortgage market, the debate has moved past access to credit v. consumer protection and is now centered on what *kind* of credit should be extended, how, and at what price.

While it was clear at the time of the Symposium that homes were entering foreclosure at a record pace, there was a vigorous difference of opinion about what to do about it. The differences revolved around how far regulations should go in an effort to prevent a repeat of the lending excesses of the prior few years. Some felt that many practices and products should be prohibited and liability for loan purchasers expanded, while others felt such remedies would in the long-run constrain access to credit and innovation in undesirable ways.

Comments following each panel were wide ranging. As a result, the best way to summarize the content and spirit of the discussion is to organize them around topic areas rather than providing an account of all that was said and in what order. Nevertheless, the topics presented here roughly followed the sequence of the Symposium, beginning with consumer decision making, then the evolution and structure of credit markets and regulations, then international comparisons, then dimensions of the recent mortgage market problems, and

remedies for the mortgage problems. Though the mortgage crisis was front and center at the Symposium, the discussions of its dimensions and possible remedies have some relevance to other consumer credit markets as well.

I. Consumer Credit Decisions

The discussion of consumer credit decisions tended to focus on how easy it is for consumers to be confused about which credit products are best suited to their needs and even about the features of the credit products they select. Other issues discussed at length were the tendency of consumers to make predictable errors in judgment (and how business can exploit these errors) and the role of trust in making selections of financial service providers.

Consumer Confusion and Information Shrouding

The theme of consumer confusion was best exemplified by a series of questions posed by a Panel 2 discussant to underscore mortgage product complexity and confusion. He began by challenging the audience to see if they knew the details of their own mortgage terms. He asked the audience to raise their hands if they had an ARM then, of those who do, if they knew the ARM first period's reset amount, if they knew their annual reset cap, and if they knew their lifetime reset cap. Even in this audience, almost no one knew the last two features of their ARMs. The discussant pointed out that ARMs have become complicated with many variations—only a fraction of which were touched upon by his questions.

Several times during the event, participants noted the complexity of credit products and the challenge of making choices with outcomes that depend on an uncertain future. Several participants throughout the event argued that borrowers do not know before the fact what terms of a loan or line of credit will be utility maximizing because the future is uncertain. Others pointed out that this can be said for the lender as well, making it difficult to fault lenders if a borrower encounters problems in repaying a loan after the fact.

Still others pointed out that there is a fundamental difference between the risks that consumers and investors face. A poor loan choice falls more heavily on consumers because they have much less of an ability to hedge risks using formal hedging instruments and are less likely to do so. One participant noted that this means the system is increasingly shifting interest rate risks from the firm to the borrower even though the firm is better able to manage this risk.

The discussions around the extent to which we understand the credit decision making process of consumers showed that advances have been made. However, several participants suggested that many of these advances are proprietary and used by businesses to maximize their financial goals. A considerable amount of time was spent on the example, discussed in the economic literature, of businesses deciding to shroud information from consumers as a way to maximize gains. A classic example of shrouded information is the lack of transparency around the costs of ink cartridges when consumers purchase a printer. An example in financial services is the late penalties and other fees associated with loans and credit card debt. The tendency for the myopic consumer to subsidize the informed consumer was discussed and is covered well in the literature. At the Symposium, however, the impact of these shrouded costs on low-income households was raised. The borrowers most apt to trigger these late fees are those with low-incomes and high short-term liquidity constraints, thus shrouding often entails a transfer from low-income to higher income borrowers.

Decision Making Biases and Errors

In general, much of the conversation around consumer decision making was around the tendency for consumers to commit certain systematic errors (biases) in making credit decisions. These are especially well documented in the literature. Several participants provided examples of how business can exploit these biases in ways that extend well beyond simple shrouding of costs. These include how choices are framed and what cognitive biases (such as optimism about the future and discounting future utilities more heavily than present ones—so-called hyperbolic discounting) are tapped by businesses. As discussed further below, some the conversation turned to ways policy makers can use these biases to promote choices viewed as more optimal from a public policy point of view.

Trust and Culture

It was pointed out that complexity of products and an uncertain future are not the only problems that confuse consumers and shape their choices. One discussant pointed out that cell phone plans are as complex as bank account features yet the usage of cell phones is much greater than traditional banking services among those with low-incomes. Beyond the

complexity of cell phone contracts, there are similar and real high dollar consequences for errors in terms of overage fees.

Indeed a critical factor in financial decision making, as suggested by Sawady in her paper, is the role of trust and culture. While the Sawady paper raised other factors as well, this one triggered a number of comments from the audience. It was noted that economists have found that culture and trust are often used as a way to help assure that transactions are fair (hence the importance of social capital to the operation of many markets). One participant pointed out that excluded groups often base their behavior on a principal of reciprocity, in which favors done among member of the group are returned by others, not infrequently without a formal accounting. Banks, she pointed out, are not part of the affinity group of low-income people, and this creates opportunities for financial institutions with greater affinity with the group to provide services and products if they meet customer wants. A case in point is check cashers and payday lenders. Another participant pointed out that there are competitive pressures on banks, and consumers apparently want things like direct human contact that are very expensive. This discourages banks from taking steps to meet the needs of these customers, so the causes of the large number of un-banked likely go beyond trust issues. Another participant noted that studies show consumers don't like hidden costs like overdraft charges and back-end fees.

Beyond understanding consumer behavior, participants suggested the importance of also surveying and studying the attitudes of providers. It could be important to understand what the brokers, underwriters and others in the industry think about current practices and how they have evolved over time.

II. Evolution of Consumer and Mortgage Credit Markets

Several of the papers presented at the Symposium described the evolution of consumer and mortgage credit markets. The evolution of the markets from ones based on rationing credit at essentially a single price under strict underwriting standards with a small menu of products to one based on risk-based pricing, more flexible underwriting, and a proliferation of products was discussed. In addition, the development of secondary markets for consumer credit and mortgage products was a subject of many remarks.

Regulation and Deregulation

The importance of federal deregulation of credit markets that occurred in and around the early 1980s in permitting products to proliferate, usury caps to be eliminated, capital markets to deepen, and new lending practices to flourish was underscored by many comments. These developments were cast as expanding access to credit and expanding the supply of funds for consumer and mortgage lending but reducing consumer protections and state autonomy in regulating credit terms and practices. In addition, the evolution of a regulatory system in which federal safety and soundness regulators apply different principals to regulating deposit-taking institutions and provide for different levels of federal pre-emption of state laws was portrayed as creating a very uneven playing field with the position of the field dependent on a financial institution's charter and, in the cases of state-chartered non-banks, what state the financial institution is chartered in. It was also pointed out that federal regulation may have actually pushed subprime lending out of the banks, and that the BASEL debate pushed loans out of portfolio. Concern over the unregulated margins was raised, as firms typically seek ways to step around regulation.

Challenges of Unbundling Lending Functions

The unbundling of loan funding, originating, and servicing from a single firm, as well as the growth of secondary markets, were characterized as key in lowering costs but also as multiplying agency risks in the system. With so many counterparties operating under different incentives and with different amounts of information, the importance of carefully monitoring and policing counterparties has increased. Yet, many felt actual agency risk management has been lacking despite its greater importance.

The evolution of the system was described as leaving consumers more susceptible to confusion and vulnerable to exploitation. Not only are products more complicated and varied but the ultimate holder of a mortgage loan and the recourse of a borrower in the event of mistreatment less obvious.

Competitive Pressures

During the course of discussion, the "race to the bottom" was discussed repeatedly. The general view was that under pressures to maintain market share, financial institutions are driven to

adopt practices deployed by others that attract customers even if these practices expose borrowers and lenders alike to risks that they may not understand well and may have a difficult time managing. Institutions must offer products and implement practices that match those of their competitors or risk losing market share. Several participants argued that competitive pressures are fierce, as deposit-taking firms and bank holding companies compete against each other and with less regulated firms, and the race for market share drives practices that ultimately may sacrifice profitability. Against this powerful tide, little can be done, some argued, unless and until the losses created by these products and practices start to cause consumer and investor losses. While some financial institutions may choose not to compete over concerns about the soundness of practices or the potential for damage to their reputations should the products and practices prove harmful to consumers and or investors, many will choose to compete. Along the way, as in the recent case of the rapid pace of innovation in loan products and practices in the mortgage market, significant damage can be inflicted on consumers and lenders. In addition, several commented that in the wake of such damage lenders have an impulse to dramatically tighten standards beyond what is necessary to combat excesses and in so doing contribute to the problem.

Ratings Agencies

Given the reliance of investors in public capital markets on the ratings of credit agencies, as well as the importance of rating agency determinations in the pricing of credit-backed securities and the amount of credit enhancement necessary to achieve a particular rating, the role of ratings agencies was raised at several points over the course of the two days. One participant argued that ratings agencies have clear structural problems, and in the current crisis one should ask “where were the rating agencies?” Another participant pointed to the common misconception that rating agencies are evaluating expected future risk and performance of a pool of loans based on information and historical analysis available at the time of the rating. They do not forecast future performance and clearly state this in footnotes. When a portfolio does not meet its expected performance, the participant continued, the agency will only up or downgrade the paper. In the recent bust, clearly the agencies reviewed recent data on performance and found that they had flawed methodologies concerning expected performance of the loan pools that they rated. Their recourse was to downgrade the securities based on more current information.

Another pointed out that, ironically, investors may have the same behavioral tendencies that can get borrowers into trouble: having faith in their trusted advisor, in this case trusting the rating agencies ability. Given that rating agencies state that they are not forecasting performance, one participant argued, when new types of loan products and terms are introduced in the marketplace perhaps the ratings agencies should flag them for investors with a no past performance (NPP) rating.

Risk Shifting

Several times, participants noted that more risks are being passed along to consumers. Examples are interest rate risk (through adjustable rate terms) and other reset risks. One participant stated that a downside of capital market innovations is that derivatives allow or promise to allow investors to hedge risks. This makes them more risk seeking. But consumers lack such protection. Thus, borrowers assume risks they have a hard time hedging while investors assume risks that they can try to hedge or can takeout insurance on. Another participant noted that many consumers do not have enough in cash savings to avert risks and many also lack insurances. Both leave consumers vulnerable to income or budget shocks from uninsured and other risks. Ironically, forced savings in homes are for many homeowners their only significant savings. But to tap it they need to borrow and use their homes as collateral. This increases risks both because more debt is incurred with the home pledged as collateral and because any disruption in the ability of homeowners to take cash out at refinance or through a second mortgage leaves them without a way of coping with income and budget shocks.

The same participant noted that the shift from mutual insurance to risk-based pricing to manage risk has not been beneficial to consumers. Risk-based pricing demands a return on investment that is often quite steep while mutual insurance demands no or only a small return on investment. He went on to say that one way to deal with undiversified risks is to sell equity shares and create a market for those shares. These can be tied to the mortgage (shared appreciation) or more freely traded in a separate market. It is also possible to take out futures contracts now.

Usury Laws and Product Prohibitions

The elimination of rate caps and the imposition of prohibitions on marketable credit products, which the Staten paper addressed, were repeatedly discussed. The paper provided a

great deal of evidence showing that usury laws decrease the supply of credit by discouraging lenders from serving populations more costly to serve than the interest rate than can be charged under caps but who have a demand for credit. More than one discussant pointed out that measuring the worth of credit laws entirely in terms of whether supply decreases may not be helpful, and suggested that it may be more helpful to look beyond whether and how many people got loans, and look instead to the terms of these loans and the performance of these loans. In some cases, shrinking supply could be good, as safety and soundness in the system are better protected and consumers less likely to fail. Generally, it was acknowledged that there is usually a negative supply response to product prohibitions and usury laws but not always. One participant argued that laws which increase consumer confidence in the safety of the loan products in the market increase demand, and supply meets the increase in demand.

There was also a discussion of the paper by Pennington-Cross and his colleagues which tested for impacts of different aspects of recently enacted state laws on the loan applications, rejection rates, and originations. The authors concluded that different aspects of the laws have different impacts and it is possible to combine these aspects deliberately to achieve certain outcomes. The discussion of the paper revealed that state laws were designed with a variety of different purposes in mind. Mostly they were aimed at preventing equity stripping rather than preventing foreclosures and did not focus on borrowers' ability to repay loans. Ohio was the first state, one participant said, to focus on repayment risk. Another participant argued that it is difficult to anticipate what practices ought to be prohibited, using as an example the teaser rates offered on 2/28 ARM loans and the practice of underwriting them based on the teaser rate. These were not products or practices that regulators anticipated. Hence, while state laws were seen as holding promise to prevent certain forms of lending viewed as excessively risky or susceptible to abuse, they were seen as difficult to calibrate to achieve shifting goals and to control unpredictable outcomes.

III. International Comparisons

International comparisons reveal how different nations deal with some of the most fundamental challenges of credit delivery systems. One observer summarized the gist of the papers on this subject stating that the solutions are rooted in the political economy and culture of each nation, and the political power of lenders. It is common for political actors to grapple with tradeoffs

between expanding access to credit and protecting consumers. This becomes increasingly challenging as credit is offered on more complicated terms and to more vulnerable borrowers.

Cross-cultural Differences

Assuming that safety and soundness are properly addressed through other regulations and oversight (not always a safe assumption), the conversation suggested that governments must address where and how much to prod the market to expand access (if the market excludes many consumers as a result of very tight underwriting practices) or restrict practices (if credit is flowing to borrowers with a high probability of defaulting or of being sold loans they do not understand or cannot manage). Several participants took the view that in the United States there is a longstanding reluctance to restrict the market or hold the industry accountable for meeting broad suitability standards. In the United Kingdom and France, there is a greater willingness to restrict credit and to establish broader standards.

In the United Kingdom and the United States, the participants noted, there is a broad political consensus that expanding access to credit to the poor and other underserved groups is desirable, while the French are concerned that it can further social exclusion. The French have a long social history of abhorring transfers from the poor to the rich that exacerbate inequality and of schemes that may leave the poor worse off. Credit extension to the poor is viewed as having a high potential to result in these transfers or make the poor worse off. One participant noted that the history of extending credit to the poor in the United States validates these concerns. The first such effort involved extending government insured mortgage credit to poor, predominantly black urban neighborhoods in the 1960s. The programs designed to deliver that credit were shut down under a cloud of scams, foreclosures, and aggressive credit peddling. In the 1980s and 1990s, credit was largely unavailable for home purchases in these neighborhoods but credit for second mortgage loans and lines of credit somewhat more so. These loans and lines were also associated with frequent charges of fraud. Arguably, the recent lending binge will end in a similar fashion. Still in most developing nations, another participant noted, the Anglo-American goal of expanding access to the poor reigns supreme. Liberalization of lending standards is occurring at breakneck speed in nations, many of which do not have a previous culture of borrowing even among the privileged.

The UK Model

The difference in mortgage and consumer credit regulations and systems in the United States and the United Kingdom is striking, even though each is designed to meet the goal of expanded access to credit while protecting consumers. The discussion turned to the Kempson paper which described how the United Kingdom has imposed several broad standards on mortgage products and sales (and had a strong self-regulatory system in place for banks offering consumer credit products). These restrained certain lending practices even as risk-based pricing and capital markets were being similarly tapped in the UK to greatly expand credit access. One observer suggested that the conclusion one might draw is that the lenders have sufficient political power such lending restraints were not passed here. Nonetheless, the UK is not without at least one area that is far less regulated than others: the extension of consumer credit by non-banks.

One participant said that from the American perspective, the system in the United Kingdom seemed like science fiction. Many of the regulations that here are viewed as having no political chance of enactment and harmful to the free flow of credit exist a plane ride away. The view that choice is always good is trumped by the view in the United Kingdom that some choices are bad and that the government has a compelling interest in preventing them. Choices are viewed as worth regulating not only if they cause potential harm to others but to also those making the choices themselves.

Factors Contributing to Success in the UK

Several participants expressed the opinion that the United Kingdom example of bank self regulation of consumer credit and broad government regulation of mortgage credit, at least thus far, holds promise that a prudentially regulated modern mortgage and consumer credit system can work to expand access to credit *and* reasonably protect consumers. Anchors of such a system include: ensuring that counterparties are all licensed, have rigorous and effective product and practice standards, and have capital available and at risk; ensuring that there are rigorous and effective mechanisms for examination and enforcement; and ensuring that sanctions for noncompliance are effective.

These anchors can be created by law or through monitored and proven rigorous self-regulation. But self-regulation works only if coverage is complete enough. One participant argued that a way to accomplish this is through federal laws that mandate participation in self-

regulatory systems. In addition, what constitutes an effective sanction, enforcement, and compliance monitoring system varies. For example, “naming and shaming” – or reputation risk—is a potent sanctioning force in the United Kingdom but may not be as potent elsewhere. Another participant noted that more countries are considering some form of self-regulation, with perhaps the engagement and at least tacit approval of government, as a way to proceed. South Africa is the most prominent current example.

Transferability of the UK Model

However, before idealizing the United Kingdom example too much, one participant pointed out that there are differences that also may not serve the UK particularly well. For example, there are no 30-year fixed rate mortgages in the UK. Costs of hedging the duration and interest rate risks of this form of lending, it was argued, are high and require a sophisticated financial system that is hard to develop. In other European countries, choices are also more limited. For example, in Germany you cannot refinance a mortgage and prepayment penalties are high in general in Europe. In addition in the United Kingdom access to mortgage credit comes at a high public cost: low-income owners can buy houses at about 60 percent below their market value by getting a government subsidy. Finally, another participant noted that it remains possible that the UK will have more mortgage problems than at present because the more tightly regulated system did not prevent a major run-up in home prices. The test will be how mortgage markets and performance are affected in the UK during the next price downturn and how this compares to the present problems in the US.

The discussion then turned to the active debate of these issues as the European Union attempts to thrash out Consumer Credit Directive. Some countries want loose protections and those that have strict protection may have to forfeit some of them to get maximum harmonization. Others see the fragmentation of consumer credit both within countries and among countries as a reason to impose more restrictive measures. The issue is whether the fence should be broad and low or high and focused.

IV. The Nature of Recent Mortgage Market Problems

The discussion at the Symposium was dominated by the nature of recent mortgage problems and what should be done about them. Most participants characterized the recent period as one in which mortgage lending got out of hand in terms of products and practices. Several used the term market failure to characterize the rising tide of defaults and foreclosures and the shut down of markets for securities backed by subprime mortgages in the latter half of 2007. Many in the audience wanted to ask questions and offer views on how mortgage markets had reached this impasse. Many views were expressed.

Roots in Housing Market Excesses

Some felt it was impossible to disentangle mortgage market excesses from broader housing market excesses. Historically low interest rates early in the 2000s and tight supplies of housing led to an unprecedented period of house price appreciation. In this environment, lenders rushed to develop ways to allow borrowers to chase products higher by lowering their initial payments. This gave rise to products that added to payment reset risks, such as ARMs with initially deeply discounted teasers, interest only loans, and payment option loans. Nearly all market participants bought homes, borrowed money, or loaned money in expectation of prices continuing to rise and of price appreciation insulating everyone from the impacts of these reset risks if they came to fruition.

Global Liquidity and Investor Risk-Return Tolerances

Others argued that at an even broader level, the willingness of investors to take on so much risk with such narrow risk-adjusted spreads over Treasuries was principally at fault. Global liquidity was so great – so much cash was looking for a place to invest—that the normal constraint on the extent to which consumers could tap credit (underwriting standards and loan pricing) did not constrain borrowing. One participant noted that investors wanted a certain yield, so the market created a product system to get them that yield. But others said that we need to acknowledge that there were huge mistakes made by the investors, including believing in the ratings offered by the rating agencies even though the products rated and underwriting applied to them were new. One participant wondered aloud “what is the value of accuracy of data out

there?” and argued that investors were willing to take bets on poor information when they could have demanded higher returns for that risk.

Push Marketing and Origination Incentives

Still others felt that the push marketing of subprime and exotic loan products was at least in part to blame. Yield spread premiums (charging an interest rate higher than the wholesale loan purchaser demands and returning the spread back in the form of an upfront fee to the originator) led to high broker commissions for these products and motivated originators to push these products. This may have led borrowers to take on risks they were ill-prepared for and may not have fully appreciated.

Was the Problem Foreseeable?

One participant noted that no one saw the depth of this decline coming. Others felt that the decline was predictable as early payment defaults rose well before payment resets, and that the loan characteristics and lack of underwriting were spelled out in prospectuses where investors could see them. Another discussant argued that when the industry developed products to help people get into the housing market based on criteria other than their ability to repay the loan this could have been seen as a warning of future failures from decreasing credit standards and increasing house prices. Others agreed, stating that accepting low and no documentation of income and assets is hardly underwriting a loan in the conventional sense.

Consumer, Lender, and Investor Dimensions

While there was considerable difference of opinion of whether or not the crisis was predictable, there was general acknowledgement that many parties played a role. Many comments were made about how borrowers did not understand what they were getting into, investors took huge risks without looking closely enough, and lenders drove down underwriting standards for short term gains in market share. Meanwhile the “middle men”, the brokers, had an incentive to generate volume rather than quality as they got paid upfront and not based on loan performance.

Some participants maintained that whether or not remote investors unknowingly purchased products that are now losing money, they played a role in fueling the market. While investors were making money off these transactions, there was little incentive to change underlying problematic

practices. There was strong consensus that bad underwriting, and a willingness of lenders to set these low standards (no doc, stated income), coupled with investors' willingness to invest in these products for high returns at least in part fueled problems. Therefore, while much of the focus in industry discussion has been on the broker practices, some argued that investors and the lenders underwriting the loans bore at least as large a responsibility.

V. Remedies

The participants at the conference advanced a range of views on what actions should be taken to remedy the problems that surfaced in mortgage markets over the last several years and to prevent them from recurring. Because the factors that led to these problems to some degree also characterize consumer lending, the remedies intended to prevent a recurrence of problems in mortgage market have parallels in these markets.

At the time of the Symposium, it was clear that the market was attempting to self correct for the problems created by the mortgage credit delivery system in bold fashion. The market for existing securities backed in whole or in part by subprime mortgages was all but shut down, and the underwriting applied to newly originated subprime mortgages and even jumbo prime mortgages significantly tightened. Standards returned to levels of stringency not seen for years and risk spreads widened considerably. One participant argued that the market will overcorrect because it tends to do things to excess, and gave the example of the lack of bids on AAA subprime and the few bids on Alt-A portfolios. This led several at the Symposium to characterize the response as an overreaction which only exacerbated the problem by making credit less available and seizing up markets. This was voiced as a major source of concern and a reason for government action to restore market confidence and liquidity.

Bold Action to Address Troubled Mortgage Loans

All participants who spoke to this issue, and there were many, concluded that the magnitude of the current problem, the potential for contagion effects in the credit markets, and the negative externality effects of defaults on neighborhoods all justify government intervention on a large scale. As one participant put it, the greatest risk is that the government will overreact to past lending practices by imposing harsh restrictions on future lending but under-react to the present crisis in loan performance and liquidity for mortgage debt. The intervention should restore order to

the market in the interests of mitigating broader damage and sparing owners who can make payments while demanding fiscal responsibility from borrowers and generating losses for investors.

Various approaches were discussed modeled after the Home Owners Loan Corporation and the Resolution Trust Corporation. Of the two, the more germane example was thought to be the Home Owners Loan Corporation because the Resolution Trust Corporation acquired assets from failing banks with deposits insured by the federal government. However, the fund that was set up did demand payments from the savings and loan industry to cover some of the costs and this was noted as an example of way to deal with past problems while keeping lenders on the line. Most participants felt that a time-limited offer to buy securities at market value by a government trust, that would then repackage the loan with a government guarantee of principle repayment and resell them, would be the best way forward. This would cause existing investors to realize losses while in one stroke creating a market for securities and allowing the government to recognize the value of its guarantee by selling the mortgages on to new investors at a different price. The idea as sketched would involve the government trust or agents working on its behalf (such as Fannie Mae, Freddie Mac, or large servicers) to try to expedite loan workouts. The worked out loans would provide partial relief for homeowners to allow them to remain current on their loans while obligating them to make restructured payments. However, several concerns were raised with such an approach, including: working out loans is a costly business that does not lend itself well to wholesale solutions, the lack of clarity surrounding the capacity of a government fund to restructure loans held in securities governed by contracts and owned by multiple parties, whether tender offers are possible, and how to avoid future intensification of moral hazards.

Assignee Liability v. Standards-Based or Product Prohibition Regulations

There was considerable discussion around whether or not the best way to mitigate agency risk in the future in a now firmly securities-based funding system is to impose assignee liability or to impose standards-based or prescriptive regulation. Some felt that imposing assignee liability would be the most successful and least prescriptive approach while others felt that relying on litigation and the fear of litigation to police the market is less effective and more disruptive. The United Kingdom example of principles-based lending based on suitability and affordability standards was viewed as worth considering in the United States context, but remembering that there are about 300 pages of regulations that back this so-called “principle-

based” regulation, underscoring the need for specificity bordering on prescription to avoid undue ambiguity in the standards. In general, many felt that relying on regulators to promulgate and enforce rules is preferable to achieving goals through creating more fertile ground for litigation. Still, the proponents of assignee liability pointed out creating legislative safe harbors for assignee liability would help bring greater oversight of counterparties while minimizing market disruptions. This could come in the form of caps on liability amounts or a legislative safe harbor such as first offering a 30-year fixed rate mortgage and independent counseling to avoid liability. And many of those who weighed in on the side of prescriptive regulations worried that they could be overly prescriptive and rigid, stifling innovation on the one hand and failing to keep up with the introduction of new undesirable products and practices on the other. One participant, in response, advanced the notion of creating something akin to the Consumers Products Safety Commission or the Federal Drug Administration that would allow standards to be set and modified more flexibly without having to go to Congress for every modification.

De-biasing Credit Consumers

There was also considerable interest expressed in developing, considering, and testing approaches that “de-bias” consumers. The concept is rooted in a great deal of research that shows that consumers have certain biases that lead predictably to systematic errors in judgment and poor credit choices. Rather than try to simply inform choices through more or better disclosures and consumer education, efforts to de-bias choices take as a starting point that even with the best disclosures and education people are still prone to unhelpful biases. Further, scholars have pointed out that many choices have inevitably to be framed by someone and that it is more desirable than not to frame choices in a way that reduces biases or uses them to steer people to choices preferred for public policy reasons.

Specific ideas for ways to de-bias customers were presented in the paper by Barr, Shafir, and Mullainathan. To address areas ways that the market exploits consumers and where the incentives between consumers and lenders are not well aligned, new rules could include sticky defaults or information debiasing on debt. Some solutions could include: an *ex-post* standards based disclosure requirement, mandatory rate sheet pricing provided to the borrower, opt-out mortgage products, broker fiduciary duties, and/or banning yield spread premiums. Lusardi also

pointed to a debiasing solution of having loan originators disclose the wholesale rate of the loan at the time of the loan negotiation.

Exploring Self Regulation

The idea of promoting the development of a more robust self-regulatory regime in the United States for mortgage credit standards, practices, and products was debated. The United Kingdom model was viewed as quite promising but some were skeptical whether the more intense nature of competition in the mortgage markets would make it less likely to be effective. Indeed, even in the United Kingdom, some felt self-regulation was unsuccessful on the consumer credit side in part because of the large number of financial institutions involved and the intensity of their competition under relatively low barriers to entry. It was also pointed out that the self-regulation that works in the United Kingdom involves external monitoring and review and a very real and active commitment on the part of the self-regulating agency to sanction its members. Some in the audience questioned whether self regulation could be effective in a litigious country like the U.S.

Loan Originator Licensing and Standards

Picking up on a distinction made by Chairman Bair about the different forms of regulation, there was also a great deal of discussion of provider-oriented regulation, especially more uniform and stringent licensing and registration of mortgage brokers. Though one participant pointed out that the mortgage brokers are expected to, and likely do in most cases, find borrowers a better deal than if they had gone to a single lender, most argued that broker licensing and standards are uneven at best and at worst make it easier for brokers to commit fraud and leave consumers too poorly protected. In the United Kingdom, in contrast, the point was made that all brokers are uniformly regulated, have to be licensed, meet rigorous standards, and give advice that must be guided by codified regulations.

The now well-established fact that broker originated loans in the U.S. have poorer average performance was raised several times as a reason to consider federal legislation aimed at the licensing and regulation of mortgage brokers. Several states have already strengthened their licensing and regulation of brokers but many felt a stiffer national standard was necessary. Others argued for the value of third-party certifications (seal of approval) of the track records of mortgage brokers as a market-driven mechanism to police brokers. Several participants argued

that wholesale lenders that sell off loans into pools sold to investors, as well as brokers, need to have more capital at risk (skin in the game) and demonstrate that they have the capacity to come up with the capital if needed. Otherwise counterparty risk is mismanaged and incentives are improperly aligned.

One participant reminded that audience that brokers may in fact get blamed for more than their fair share of the problem. Another countered that even if only a few brokers engage in unfair practices, certification and licensing may help the broker network improve without imposing too harsh a burden on it.

Addressing Yield Spread Premiums

The practice of allowing yield spread premiums as a way to compensate originators was also singled out as a problem. Some argued that lenders should be required to disclose such compensation in a clear way to borrowers so that they can see and understand it. In fact, the Federal Reserve Board has recently proposed changes to Regulation Z where lenders would be prohibited from compensating brokers through yield spread premiums, unless the broker entered a written agreement with the consumer disclosing the broker's total compensation and other facts before the consumer applies for the loan or pays any fees. This proposal could radically change the current norm in the subprime industry, noted at the Symposium, where yield spread premiums compensate brokers able to get a borrower to agree to an interest rate higher than rates posted by the lender. Some banks are proposing other compensation structures, such as a no or flat-fee mortgage, as a way to gain market share. Bank of America's "no fee mortgage PLUS" product, for example, advertises no application fee, no closing costs, and no private mortgage insurance yet clearly these costs are embedded in the interest rate pricing. Finally, one participant suggested that certain practices be prohibited when yield spread premiums are present, giving as an example prohibiting prepayment penalties while others thought yield spread premiums should be banned.

Improving Disclosures

Another regulatory approach discussed at length was disclosure. One author argued that while disclosures don't inform consumers as much as some had hoped, evidence suggests that disclosures do reduce risk and hence narrow risk-adjusted spreads. He argued this was the

purpose of disclosure laws in the first place. Several people pointed out that the Truth in Lending Act was originally conceived as a compliment to state law. While the Federal Reserve has worked to improve disclosures with the growing complexity of products themselves, many questioned whether these disclosures were clear and helpful or had become too onerous and tortured for too little payoff. Thus, some at the Symposium questioned whether it was time to overhaul and simplify the system while others suggested ways disclosures might be improved. One idea proposed was to require lenders to price individual features of loan products separately rather than rolling it all into an Annual Percentage Rate, such as separately identifying finance charges, prepayment penalties, low documentation charges, and payment option charges. Bundled products, it was argued, a harder to compare. Many felt that disclosure and guarantees of pricing and costs should come earlier in the process, costs should be unbundled and precise, and the cooling off period from signing for a loan and committing to it should be lengthened. Still, considerable skepticism was expressed about whether disclosures can deliver on what is expected of them in terms of informed consumer choice.

Developing Product and Provider Certifications

Beyond these regulatory solutions and calls for government sponsored bailouts, a number of other approaches to improving consumer protections while preserving their choice were advanced. One involves building on the finding that trust is so important in consumer credit decisions. While investors will be increasingly looking for a ratings agency they can trust, consumers also have a heightened awareness that many loan products are problematic in the current marketplace. As trust erodes in the system, there is an opportunity to recreate a trusted network or certification. One participant argued that there are models from other industries that could be applied such as the certification of specific products or processes, such as the Forest Stewardship Council and the Fair Trade seals of approval. This could be applied through a third party network in the mortgage realm, and could be supported through better truth in lending disclosures.

Providing More Financial Education and Advice

Another remedy discussed was the provision of more financial education or advice. There was a general consensus that informing consumers is a worthy goal. However, how to do this with best effect was the subject of considerable debate. Some argued that financial literacy should be a central part of the high school curriculum. Apart from differences of opinion about what such a curriculum ought to contain, however, most agreed that this is desirable.

However, several participants felt strongly that general financial literacy is not sufficient. Specialized information is often needed in and around key financial decisions points. Education and disclosures must ensure that this specialized information is available and, as much as possible, understood by the consumer.

However, some concern was expressed that consumers have not yet demonstrated that they value education and information. Certainly, they are often reluctant to pay separately for it and often do not want it to slow down the process of getting credit. Furthermore, the market is complex. Even if consumers are literate and disclosures are expanded significantly, consumers still have to sort through multiple product options offered by multiple lenders. Transparency in pricing would help, but it is still quite possible that a consumer could have gotten a better deal even in the absence of any fraud or neglect on the part of their lender. It does not help, though, as at least one participant pointed out, that many borrowers believe that their broker is legally or morally obligated to get them the best price and terms. Nor does it help that brokers are unwilling to make such a pledge and there is no equivalent of a buyer's real estate broker among mortgage brokers.

On the other hand, one participant stated that tailored advice which is universally viewed as appropriate is difficult to provide because what appears the right choice from an objective perspective may not suit the needs or preferences of the consumer. The right choice may not be the objectively the choice most likely to produce the lowest cost. A broker that represents that they are getting a consumer the best price and terms cannot be assured that a consumer will follow their advice and would not want liability risk if challenged.

The idea of a "trusted advisor" is often bandied about and this conference was no different. But several participants pointed out that it is unclear who this trusted advisor should be and whether those assigned this label deserve it. Should it be the broker, the real estate agent, a lawyer? How can the government help increase the odds that advice dispensed by any of these

parties can be trusted? Are any of these agents willing to self regulate or consent to government regulation to assure this?

As an alternative to consumer education, which may or may not be effective in countering the effects of push marketing and information overload, there was a suggestion to tell consumers what consequences they will have along the way. One example is to tell people when they are about to trigger a credit problem, such as “you are about to overdraw your account, and the penalty fee is x”. Having the lender notify the client when they are triggering a problem attaches the behavior to the outcome and addresses underlying consumer biases such as short-term, present time focus.

Building Savings and Creating Alternative Investments

Yet another remedy discussed for improving credit outcomes for consumers was to encourage consumers to save and to provide better wealth building alternatives to homeownership. Participants mentioned many innovative ideas to promote savings, such as using the Emerald Card as a savings vehicle and using lottery-linked savings accounts. An international expert pointed to the range of financial products available in rural India and another pointed to international banks that charge just \$25 to open an account.

Several participants pointed out that homeownership is not for everyone and should not be our primary housing policy. But there was general agreement that there are not good alternatives to homeownership for wealth building because other investments, such as stock and bonds, are not frequently made by consumers with borrowed funds. The leverage that exposes homeowners to risks also creates the potential for large returns. Therefore, there was considerable discussion of how homeowners could hedge themselves better against the risk that a home will fall in value. Ideas discussed included derivative products offered to owners, selling equity participation stakes into a secondary market, and shared equity mortgages.

Working with and Augmenting the Servicing Industry for Workouts

In commenting on a paper that explored servicing practices, it was noted that the servicing industry is the key to risk management once borrowers miss a payment. But a principal industry complaint expressed at the Symposium is that a large fraction of borrowers (at least in the mortgage space) will not return messages from their servicers. Quick responses are essential,

one observer explained, because after a month in arrears it is not uncommon for consumers to take on other debts to try to tide them over, adding to the difficulty of later working out their debts. Some argued that the first call to a borrower is not from the loss mitigation department but from the collections department. The latter can be very off putting. Thus, participants noted the value of hotlines operated by trusted nonprofits and advertised by government and other community groups.

Several people commented that the economics of servicing is radically altered in a market with slack demand and falling home prices. The costs of working out loans relative to letting them move through foreclosure makes workout become increasingly attractive. Many figures for loss severities were tossed out, ranging from an average \$25,000-\$50,000 in normal condition to closer to \$100,000 when prices are falling. Workouts can cost far less. But when the economics improves for workouts, others pointed out, it is also usually a time when revenues for servicers are falling and they lack the revenues and capacity to act more aggressively on workouts. Servicers are under pressure to cut general and administrative expenses just when they need to spend more. In addition, all at once there is a major surge in servicing capacity, often after a period where an expanding market had reduced the demand for servicing. Experienced servicers are then in short supply and their services costly. This increases the importance of experienced third-parties that offer to help with workouts, can handle large volumes, and receive funding from other sources and pools funding from servicers.

Industry capacity to do workouts was singled out as a major concern. The importance of exploring more wholesale options to workouts was highlighted but many expressed skepticism that workouts could be anything less than a retail process. Participants pointed out that this means servicers will have to be engaged even in government funded trust schemes.

A discussion of state foreclosure laws prompted several to underscore that the costs of complying with foreclosure laws are priced into mortgage rates and result in a transfer from those that do not default to those who do. States laws that add delays and uncertainties are the most costly. Some participants called for reform to foreclosure laws as a way to expedite the resolution of failed loans and disparaged calls for measures to address mortgage problems through moratoriums on foreclosures.

With so much need of workouts in the mortgage market and the possibility that performance of consumer credit may also soon deteriorate, several participants mentioned that

debt written down is a taxable event for the borrower and this prevents many workouts from occurring. Several participants called for a suspension of these rules in times of mortgage crises as a way to prevent foreclosures that have significant negative externalities and justify government tax expenditures. Because the lender/investor loses money in a write down, it is not a bail out of lenders/investors.

VI. Conclusions

The two-day long Symposium prompted a rich conversation of the implications of new world of consumer credit and mortgage finance and what can be done to improve these sectors. The conversation turned much more to what regulations ought to be promulgated and what government interventions might be necessary to help workout mortgage problems than might have been case had the conference taken place a year earlier when more obvious cracks in the foundation of mortgage lending were starting to emerge.

Augmenting the material presented in the papers, what emerged was a deeper appreciation of the nature of today's consumer and mortgage credit markets, the benefits they have brought and the risks they have exposed borrowers and the financial system to, and the possible remedies to problems encountered.

APPENDIX A: AGENDA

**UNDERSTANDING CONSUMER CREDIT:
A NATIONAL SYMPOSIUM ON EXPANDING ACCESS,
INFORMING CHOICES, AND PROTECTING CONSUMERS**

**Harvard Business School
Boston, Massachusetts
November 28 and 29, 2007**

Wednesday, November 28, 2007

8:30 AM: REGISTRATION

10:15 AM: WELCOME, Nicolas P. Retsinas, Symposium Chair
Joint Center for Housing Studies of Harvard University

10:30 AM: INTRODUCTION AND OVERVIEW, Eric S. Belsky
Joint Center for Housing Studies of Harvard University

11:00 AM: PANEL 1: CONSUMER CREDIT DECISIONS

Financial Decision Making Processes of Low-Income Individuals

Presented by Edna Sawady, Market Innovations Inc.

Where does it go? Spending by the Financially Constrained

Presented by Shawn Cole, Harvard Business School

Fair Lending Testing: Best Practices, Trends & Training

Presented by Paul Lubin, Informa Research Services

Moderator: Eldar Shafir, Princeton University

Discussants: John Campbell, Harvard University

Chuck Muckenfuss, Gibson, Dunn & Crutcher

12:15 PM: LUNCH SPEAKER: Julie Williams, Chief Counsel, Office of the Comptroller of the Currency

1:45 PM: PANEL 2: THE EFFECTS OF CAPITAL MARKETS, PUBLIC INFORMATION, AND REGULATORY STRUCTURE ON THE SUPPLY OF CREDIT

The Legal Infrastructure of Subprime and Nontraditional Home Mortgages

Presented by Patricia McCoy, University of Connecticut

Imperfect Information and the Housing Finance Crisis

Presented by Richard K. Green, The George Washington University

Wednesday, November 28, 2007 (continued)

Enlisting Market Mechanisms to Police the Origination of Home Mortgages

Presented by Howell E. Jackson, Harvard Law School

Moderator: Ellen Seidman, ShoreBank Corporation

Discussants: Steve Joseph, Sandler O'Neill and Partners

Daniel Bergstresser, Harvard Business School

3:00 PM: PANEL 3: CONSUMER DISCLOSURES AND PRODUCT REGULATION

The Impact of Credit Price and Term Regulations on Credit Supply

Presented by Mike Staten, The George Washington University

The Impact of Predatory Lending Laws: Policy Implications and Insights

Presented by Anthony Pennington-Cross, Marquette University

Should Consumer Disclosures Be Updated?

Presented by Thomas A. Durkin, Federal Reserve Board of Governors

Moderator: Elizabeth Warren, Harvard Law School

Discussants: Elizabeth Renuart, National Consumer Law Center

John Sepulveda, National Association of Mortgage Brokers

4:30 PM: PANEL 4: HELPING CONSUMERS MAKE BETTER CHOICES

Financial Literacy: An Essential Tool for Informed Consumer Choice?

Presented by Annamaria Lusardi, Dartmouth College and National Bureau of Economic Research

Behaviorally Informed Home Mortgage Credit Regulation

Presented by Michael Barr, University of Michigan

Helping Consumers Make Better Mortgage Choices

Presented by Bill Apgar, Joint Center for Housing Studies of Harvard University

Moderator: Joe Belew, Consumer Bankers Association

Discussants: Keith Ernst, Center for Responsible Lending

Kevin Rhein, Wells Fargo Financial

5:45 PM: SESSION ADJOURNS

6:00 PM: RECEPTION

7:00 PM: DINNER KEYNOTE ADDRESS: Sheila Bair, Chairman of the FDIC

Thursday, November 29, 2007

8:30 AM: OPENING REMARKS, Eric S. Belsky
Joint Center for Housing Studies of Harvard University

8:45 AM: PANEL 5: MANAGING RISKS FOR THE BENEFIT OF CONSUMERS
Using Financial Innovation to Support Savers: From Coercion to Excitement
Presented by Peter Tufano, Harvard Business School

Identifying, Managing and Mitigating Risks to Borrowers in Changing Mortgage and Consumer Credit Markets
Presented by Susan J. Smith, Durham University

Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs
Presented by Amy Crews Cutts, Freddie Mac

Moderator: Ken Wade, NeighborWorks America
Discussants: George McCarthy, Ford Foundation
Karen Pence, Federal Reserve Board of Governors

10:15 AM: PANEL 6: PROTECTING AND EMPOWERING CREDIT CONSUMERS IN THE OECD NATIONS

Looking Beyond Our Shores: Consumer Protection Regulation Lessons from the UK
Presented by Elaine Kempson, University of Bristol

Consumer Protection in French and British Credit Markets
Presented by Gunnar Trumbull, Harvard Business School

Moderator: Katherine McKee, Consultative Group to Assist the Poor
Discussants: Duncan Kennedy, Harvard Law School
David Porteous, Bankable Frontier Associates

11:15 AM: WRAP UP PANEL DISCUSSION ON IMPLICATIONS

Moderator: Nicolas P. Retsinas, Joint Center for Housing Studies
Respondents: Konrad Alt, Promontory Financial Group
Sandy Braunstein, Federal Reserve Board of Governors
Bill Longbrake, Financial Services Roundtable
Joseph A. Smith JR, North Carolina Commissioner of Banks

12:45 PM: CONFERENCE ADJOURNS

APPENDIX B: PARTICIPANT LIST

UNDERSTANDING CONSUMER CREDIT: A NATIONAL SYMPOSIUM ON EXPANDING ACCESS, INFORMING CHOICES, AND PROTECTING CONSUMERS

**Harvard Business School
Boston, Massachusetts
November 28 and 29, 2007**

As of November 26, 2007

Frank Alexander, Emory University School of Law
Konrad Alt, Promontory Financial Group LLC
William Apgar, Joint Center for Housing Studies of Harvard University
Robert B. Avery, Federal Reserve Board
Chairman Sheila Bair, Federal Deposit Insurance Corporation
Pamela Baldwin, Joint Center for Housing Studies of Harvard University
Michael Barr, University of Michigan Law School
Joe Belew, Consumer Bakers Association
Eric S. Belsky, Joint Center for Housing Studies of Harvard University
Daniel Bergstresser, Harvard Business School
Suzanne Boas, Consumer Credit Counseling Service of Greater Atlanta
Sandy Braunstein, Board of Governors of the Federal Reserve System
Donald Brewster, Origen Financial, Inc.
David Buchholz, Federal Reserve Board
Julie Bush, Federal Trade Commission
John Campbell, Harvard University Department of Economics
Jim Campen, Americans for Fairness in Lending
Karl Case, Wellesley College
Prabal Chakrabarti, Federal Reserve Bank of Boston
Jeanne Charn, Harvard Law School
Elyse Cherry, Boston Community Capital
Shawn Cole, Harvard Business School
William F. Cotter, City of Boston
Marsha J. Courchane, CRA International
Ben Creo, Harvard Business School
Amy Crews Cutts, Freddie Mac
Zhu Xiao Di, Joint Center for Housing Studies of Harvard University
Lei Ding, University of North Carolina, Chapel Hill
Rachel Drew, Joint Center for Housing Studies of Harvard University
Thomas A. Durkin, Federal Reserve Board
Elizabeth England, Joint Center for Housing Studies of Harvard University
Keith Ernst, Center for Responsible Lending
Ren Essene, Joint Center for Housing Studies of Harvard University
Angela Flynn, Joint Center for Housing Studies of Harvard University

Jody Freeman, Harvard Law School
Drew Fudenberg, Harvard University Department of Economics
Kimberly Gartner, Center for Financial Services Innovation
Caleb Gibson, Demos: A Network for Ideas & Action
Ed Glaeser, Harvard Kennedy School of Government
Edward Golding, Freddie Mac
Gina Govoni, Massachusetts Housing Partnership
Richard K. Green, The George Washington University
Jackie Hernandez, Joint Center for Housing Studies of Harvard University
Howell Jackson, Harvard Law School
Nancy Jennings, Joint Center for Housing Studies of Harvard University
Stephen L. Joseph, Sandler O'Neill & Partners LP
JoAnn Kane, Social Compact
Elaine Kempson, Personal Finance Research Center
Duncan Kennedy, Harvard Law School
Jeffrey M. Lazerson, Mortgage Grader, Inc.
Marc Loewenthal, New Century Financial Corporation
Bill Longbrake, Financial Services Roundtable
Paul Lubin, Informa Research Services
Annamaria Lusardi, Dartmouth College
George McCarthy, Ford Foundation
Pat McCoy, University of Connecticut School of Law
Daniel McCue, Joint Center for Housing Studies of Harvard University
Kate McKee, Consultative Group to Assist the Poor
Douglas McManus, Freddie Mac
Bill Merrill, Freddie Mac
Cantwell F. Muckenfuss, Gibson, Dunn & Crutcher LLP
Sendhil Mullainathan, Harvard University
Arthur J. Murton, Federal Deposit Insurance Corporation
Kevin Park, Joint Center for Housing Studies of Harvard University
Karen Pence, Federal Reserve Board
Anthony Pennington-Cross, Marquette University
Kevin Petrasic, OTS
Mark Pinsky, Opportunity Finance Network
David Porteous, Bankable Frontier Associates
Elizabeth Renuart, National Consumer Law Center
Nicolas P. Retsinas, Joint Center for Housing Studies of Harvard University
Kevin Rhein, Wells Fargo Card Service
Ira Rheingold, National Association of Consumer Advocates
Katherine Samolyk, Federal Deposit Insurance Corporation
Edna Sawady, Market Innovations Inc.
Ellen Seidman, Shore Bank Corp.
John Sepulveda, National Association of Mortgage Brokers
Eldar Shafir, Princeton University
Susan Smith, Durham University

Joseph A. Smith, Jr. , N.C. Office of the Commissioner of Banks
Mike Staten, The George Washington University
John Thompson, H&R Block
Laurel J. Traves, Joint Center for Housing Studies of Harvard University
Gunnar Trumbull, Harvard Business School
Bob Y. Tsien, Freddie Mac
Peter Tufano, Harvard Business School
Susan M. Wachter, The Wharton School, University of Pennsylvania
Kenneth D. Wade, NeighborWorks America
Elizabeth Warren, Harvard Law School
Abbe Will, Joint Center for Housing Studies of Harvard University
Julie Williams, Office of the Comptroller of the Currency
Mark Willis, JP Morgan Chase
Peter Zorn, Freddie Mac