Joint Center for Housing Studies
Harvard University

Moving Forward: The Future of Consumer Credit and Mortgage Finance

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Contents

Introduction

By the fall of 2008 the severe problems in U.S. credit markets that began with rapid erosion in the performance on nonprime mortgages in 2007 and then spread to nonprime consumer credit and commercial mortgages helped spark a global financial crisis. Credit markets were seizing up. The U.S. government was expending hundreds of billions of dollars to ward off a complete collapse of the financial system. With home foreclosures estimated at more than 2 million a year, personal bankruptcies rising, large financial firms failing or on the brink of failure, and widespread fear and uncertainty about the ability of the financial system to weather the storm, references to the possibility of another Great Depression were not mere hyperbole. While there is debate about the fundamental causes of the crisis, many have argued that an increase in the complexity of both financial products and markets, coupled with a failure of the regulatory structure to evolve along with the changing market, played a critical role.

By the start of 2010 pressure mounted to undertake a series of regulatory reforms would be enacted given the seriousness of the crisis, the amount of funds expended to prevent the collapse of financial titans like AIG, and the fact that Fannie Mae and Freddie Mac were taken into federal conservatorship. The decisions made as part of the dual process of enacting a financial reform bill—which came to pass with passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010—and implementing the mandates of this bill will shape the financial system for decades to come. These changes will have important implications regarding both the pace of future economic growth as well as the opportunities for different segments of the population to share in this growth

To help illuminate this policy debate, in February 2010 the Joint Center for Housing Studies of Harvard University hosted a two-day symposium that considered the future of consumer credit and mortgage finance in the light of the financial crisis and lessons learned from it. The symposium was supported by the Ford Foundation, Freddie Mac, and NeighborWorks America. The goal of the symposium was to explore how public policy can facilitate access to credit for low-income households that is not unduly risky or costly. The symposium was built around 15 papers commissioned from leading academics and practitioners in these fields. Beyond the papers themselves, the value of the symposium also consisted of the ideas and points of view expressed in the discussion that took place among the dozens of leaders assembled for the event from the public, private, non-profit, and academic sectors.[1] While the conference featured a special focus on mortgage credit, other forms of consumer credit were also evaluated and discussed, including credit card lending and payday lending.

Several months following the symposium the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law, placing the discussions into a new context. The passage of this legislation has brought some clarity to the direction and nature of the reforms, but there are still numerous decisions left to regulators to implement the mandates of this law to reshape the nation's financial system. Thus, as we look ahead to 2011, the ideas and research presented at the symposium continue to offer a valuable framework for policy discussions about these remaining choices.

This paper synthesizes the symposium proceedings, drawing upon the presentations and discussion at the event as the well as the papers themselves. Rather than present a linear summary of the event, this paper is organized around a framework suggested in part by the organization of the symposium and the paper by John Campbell and his colleagues that were also echoed by several participants at the symposium.[2] Essentially, this framework suggests that an evaluation of how the nation should move forward from this crisis should proceed in three steps. The first step is to take stock of the public interest in the operation of the financial system. While there may not be agreement about what the goals of financial market reform ought to be, this review will at least highlight the reason lawmakers should not ignore them. The next step is to assess the causes of the financial crisis to understand the failings of the existing system. The last step is to then frame options for reforming the financial system to better serve the public interest while addressing the failings exhibited by the recent financial crisis. The paper consists of three main sections synthesizing the symposium's findings in each of these areas.

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[1] The papers are presented in Appendix A. Participants in the symposium are presented in Appendix B.

[2] John Campbell, Howell Jackson, Brigette Madrian, and Peter Tufano, "The Regulation of Consumer Financial Products: An Introductory Essay with a Case Study on Payday Lending."

The Public Interest in Consumer Credit and Mortgage Market Operations

Decisions about how to strengthen and reform the financial sector need to be grounded in an understanding of the public interests at stake. A clear delineation of these interests can both help to frame the decisions to be made and to serve as a goalpost toward which efforts at reform are aimed. The public interest in the operation of consumer credit and mortgage markets can be characterized as falling into four areas: ensuring the safety and soundness of the financial system, realizing the economic gains from efficient capital markets, accounting for both positive and negative externalities of private actions, and addressing concerns about whether the distribution of financial opportunities and outcomes are meeting social needs and are equitable. The inherent conflict between some of these public interests—and the need for government to choose how to balance these interests—was one of the key themes of the symposium. The papers by Eric Belsky and Susan Wachter and by Campbell et al. provide frameworks for understanding key elements of the public's interest in the operations of the markets for consumer credit and mortgage finance.[3]

Ensuring the Safety and Soundness of the Financial System

As the financial crisis has all too clearly illuminated, the public has a compelling interest in ensuring the safety and soundness of the financial system. Consumer credit and mortgage markets account for a large share of all private liabilities in the U.S. In 2008, households held $14.3 trillion in liabilities, including $10.5 trillion in mortgage debt and $2.6 trillion in credit card debt. In comparison, total corporate debt was slightly less than half as large at $7.10 trillion (Campbell, et al.). When consumer credit markets and residential mortgage markets experience a crisis, it affects a large share of the U.S. economy—and given the increasing global nature of financial markets these shocks are likely be felt around the world.

As Belsky and Wachter note, "Unfettered, consumer and mortgage markets operate in ways that can, and have produced serious market failures." These failures have significant costs to society, both from the need for public funds to rescue essential financial institutions and from

[3] Eric S. Belsky and Susan Wachter, "How to Conceptualize the Public Interest in Financial Services."

the broader economic fallout that results from these financial crises. As the financial crisis unfolded in 2008 into 2009 the unemployment rate about doubled from 5 to 10 percent—a level not seen since 1982. In addition to the hardship caused by such high levels of joblessness, the loss of household wealth from falling values of homes and financial assets has been staggering. According to the Federal Reserve Flow of Funds Accounts, from 2007 to the first quarter of 2009 household net worth declined by nearly $16 trillion, or 25 percent of the 2007 level. While household net worth has since rebounded due to recoveries in both housing and financial asset markets, as of the end of 2009 household net worth was still $10 trillion below the 2007 peak. Clearly, there is a strong public interest in maintaining the safety and soundness of the financial system.

It is also important to keep in mind that it is possible to address concerns about the level of systemic risk while not addressing concerns about the level of risk being borne by individual borrowers. At the symposium, a participant argued that there were really two different mortgage market crises. The first occurred through the early part of the 2000s, with failure rates among subprime mortgages of about 20 percent. These failures were devastating for the individuals affected and the surrounding communities—which were predominantly minority, urban neighborhoods. But these failures did not threaten the health of the overall financial system and so did not rise to the level of a national crisis. It was only when the failures of the mortgage market became much more widespread and were amplified throughout the financial system by a host of complex financial instruments that the national crisis ensued. In reforming the financial system, it is important to consider not just the level of systemic risk that the country should allow, but also the level of individual risk that borrowers should be allowed to assume.

Accounting for Externalities of Private Decisions

There are a wide variety of social consequences—or externalities—associated with private decisions on the extension of credit that may lead to inefficient allocations of capital. While some of these externalities are positive—where the benefits to society from a given transaction are greater than the benefits realized by the parties to the transaction—there are also a number of potentially negative externalities.

In particular, the conduct of financial institutions in dealing with consumers can lead to negative externalities. While lenders possess clear information about the least cost credit products that consumers qualify for, this information is often not easily obtained by consumers. Consumers may thus end up with credit that is more costly than necessary or with products that they should not have purchased, resulting in allocative inefficiencies. Similarly, if creditworthy borrowers are charged more or denied credit as a result of discrimination there is a loss to society as capital is not directed to its most productive uses. Given existing residential segregation by race, ethnicity, and income, discrimination in credit markets will also tend to reduce investment levels in specific neighborhoods, creating negative impacts on surrounding residents and businesses as well. These types of market failures provide strong efficiency arguments for efforts to protect consumers in financial markets.

Similarly, the costs of failed financial institutions are often not fully borne by the failed firms themselves. As recent history points out all too vividly, taxpayers may be left holding the bag for the private financial decisions of these firms. Even if the public sector does not pick up the tab for these failures, private counterparties of failed financial institutions may also suffer.

There are also situations where there are positive social externalities from private credit transactions. These are most commonly thought of with regard to homeownership. Beyond the potential for individuals to benefit from homeownership, Belsky and Wachter outline the evidence for the social benefits of homeownership, including better educational and economic outcomes for children and greater civic involvement by owners. While these benefits are hard to measure empirically, on the whole, existing evidence suggests that homeownership does confer benefits. But as Michael Lea's paper points out, the U.S. provides substantial support for homeownership both through the tax system and through various means of public support for the mortgage finance system.[4] While the original development of these policies can be traced to a variety of political and policy goals, the individual and social benefits of homeownership help to justify their continuation.

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[4] Michael Lea, "Alternative Forms of Mortgage Finance: What Can We Learn From Other Countries?"

While there may be some debate about the extent of positive social benefits from homeownership, there is little debate about the significant negative consequences from foreclosures that result from failed homeownership both for property values in the surrounding neighborhood and for the fiscal health of the cities and towns where they occur. Neither homeowners nor lenders consider these broader impacts in their decisions regarding foreclosures. The public has an interest in influencing private decisions regarding homeownership and foreclosure to account for these broader social impacts.

Realizing Economic Gains from Efficient Capital Markets

The economic gains from efficient capital markets can be substantial. Well-functioning securitization markets play a key role in fostering these efficiency gains, serving to channel investment capital from all over the world to a wide variety of uses. If properly organized and managed, these markets can increase liquidity, lower costs, and support a more efficient distribution of resources, contributing to greater overall economic growth. By dispersing risk, these secondary markets can also help to reduce systemic risk. Innovation in these markets can lead to substantial efficiency gains, by tapping new sources of capital, reducing transaction costs, and achieving better allocations of risk to parties best able to bear these risks.

But as one industry observer noted in his remarks, while these are the presumptive benefits of securitization, the mere existence of an active secondary market does not ensure that these benefits will be realized. There are a variety of ways in which the conditions needed for efficient markets to operate are lacking absent collective action to address these deficiencies. In particular, given the variety of actors involved in the chain of financing, beginning with the borrower and flowing through from loan origination to the pooling of loans for sale to the ultimate investors, the financial system is rife with situations of asymmetric information and principle-agent problems. There is also a variety of efficiency gains associated with standardization in transactions, but such standardization is difficult to achieve by individual actors in the system. To address these failings in the market, steps need to be taken to promote transparency and to foster standardization, so that risks are properly understood and managed, and to ensure that the interests and incentives of originators and investors are aligned.

Addressing Social Needs and Equity Considerations

In addition to issues related to economic efficiency, there is also a strong public interest in promoting fair and equitable access to consumer credit and mortgage finance products by low-income and socially disadvantaged households. Households at all income levels use credit to smooth their consumption of goods and services over time. Short-term credit can help with fluctuations in income, while long-term credit can help households afford investments that have high upfront costs but long-term returns—such as housing or education. For low-income households with little or no savings who are more susceptible to substantial fluctuations in income, access to affordable short-term credit to smooth consumption may be essential to their well-being. Investments in homeownership and education can also make substantial contributions to the long-term wealth accumulation for these households. As Eugene Ludwig (former Comptroller of the Currency) observed, credit is a powerful tool for building a better future. Credit is thus an opportunity good that lower income households should not be denied.

The paper by Tamara Draut and Jose Garcia presents a compelling portrait of the financial challenges facing low-income households.[5] Between 2000 and 2007 real family incomes in the bottom quintile dropped by 5.5 percent, while those in the next lowest quintile experienced a decline of 1.5 percent. At the same time that income in the bottom half of the distribution was falling, health care and housing costs were rising, putting these households in a financial squeeze. To illuminate the credit needs of lower-income households, Draut and Garcia present findings from a survey of 1,200 low- and moderate-income adults who reported carrying credit card debt for at least three months. The results suggest that, at least in part, a need to provide for basic necessities of life has contributed to the high levels of debt among the respondents. On average, respondents had about $10,000 in credit card balances. Among survey respondents, the most common factor cited as contributing to their outstanding debt was medical expenses, reported by 52 percent of respondents. Other common factors included car repairs (41 percent), home repairs (32 percent), and the purchase of a major home appliance (25 percent). Thirty-seven also reported using credit

[5] Tamara Draut and Jose Garcia, "Unfairness in Life and Lending: Credit and Low-Income Americans."

cards to pay for basic living expenses such as rent, utilities or groceries, due to a lack of cash for these expenses. On the other hand, the survey also revealed that 48 percent of respondents reported that small non-essential goods and services (such as meals, entertainment, and clothing) also contributed to their debt levels, while 29 percent reported that large non-essential purchases (such as vacations or televisions) contributed. Still, the large share reporting using credit to cover essential items—many of which can be quite costly to those with low incomes—is dispiriting and underscores the importance of access to credit for low-income households.

In addition to relying on credit card debt, low- and moderate-income households also turn to payday loans, rent-to-own stores, and other forms of high-cost short-term credit to help make ends meet. When all fees are taken into account, these loans often have effective annual interest rates that exceed 400 percent. Such interest rates raise concerns about whether lenders are taking advantage of borrowers' lack of knowledge and desperate need for credit to charge such excessive rates. Similar concerns have been raised about the disproportionate concentration of higher-cost subprime mortgage loans, autos loans, and credit cards among minority homeowners prior to the collapse of this market. Many of the discussants at the symposium questioned whether the cost of credit available to these needy households has been fairly priced. The advent of risk-based pricing raises concerns that variations in pricing made it easier for lenders to charge borrowers higher prices and had an incentive. The paper by Peter Zorn and Marsha Courchane found that while there was an increase in the range of credit risk taken on by lenders during the height of the lending boom, there was not a dramatic increase or decrease in risk-based pricing. Risk-based pricing was more evident among subprime loans than prime loans, but within the subprime market segment they did not find evidence that low-income or minority neighborhoods or borrowers were differentially impacted by risk-based pricing because the spreads charged for risk narrowed so dramatically.[6] But while there is not evidence that these groups were treated differently within the subprime segment, it still leaves open the possibility that they were unnecessarily channeled into the subprime market.

[6] Peter Zorn and Marsha Courchane, "A Changing Credit Environment and Its Impact on Low-Income and Minority Borrowers and Communities."

While there was disagreement about whether risk-based pricing has been beneficial for consumers, several points were stressed as key by many participants. First, there is a public interest—both for reasons of equity and economic efficiency—for banning discriminatory treatment. Second, the public also has an interest in ensuring that borrowers are not being gouged due to unfair or deceptive practices by lenders. Unfortunately, it is challenging to identify clear cases of discriminatory treatment or unfair practices as there is often no bright line between these practices and aggressive—but legal—marketing tactics.

The paper by Rachel Schneider and Melissa Koide also acknowledges that there are real barriers to providing low-cost short-term credit both due to high transaction costs for small denomination loans and because of the real risks of not being repaid.[7] Similar arguments can be made about the cost of mortgage lending to riskier borrowers. Thus, to some degree, the high cost of credit for low-income households often does, in fact, reflect the actual cost of providing this credit. However, it is unclear whether rates presently charged are necessary for short-term credit in all cases so there may be a role for government intervention to try to bring down costs. Schneider and Koide, for example, identify several ways in which the public sector could help to foster the development of more affordable short-term credit products, such as by helping to promote standardization to create greater liquidity or by investing in technology systems to lower costs.

Even if the high cost of credit for low-income households is justified by the true costs of these products, the public may have an interest in trying to reduce these costs out of concerns for the well-being of disadvantaged households. As described above, a sizeable portion of debt among low-income households results from their need to meet critical household expenses, including medical costs. Given the high costs of this credit, these households can get caught in debt traps, where the high cost of credit exacerbates their financial difficulties, sinking them deeper into debt, and greatly impairing opportunities for improving their lives through savings and investment.

[7] Rachel Schneider and Melissa Koide, "How Should We Serve the Short-term Credit Needs of Low-Income Consumers?"

Overall, the discussion of these issues at the symposium touched upon the notion that while gaining access to credit is a need—often a desperate need—of economically disadvantaged households, it is not generally viewed as an individual's right. An important question for public debate is the extent to which equity concerns should prompt the government to take action to increase the availability of affordable credit options. But addressing this concern likely requires some form of subsidy, raising further questions about who should bear this cost and how the benefits should be distributed.

Reconciling Competing Interests

The public interests described above can be distilled into a set of potential objectives for reform of the financial system. For example, interests in both social needs and economic efficiency lend support to the goals of expanding *access* to credit and promoting *affordable* credit. The public interest in the safety and soundness of the financial system leads to the goal of limiting the *degree of risk* borne by the financial system. Concerns about externalities, economic efficiency, and equity also suggest the need to ensure the *suitability* of credit products used by individual consumers. Finally, the public interest in realizing economic gains from efficient capital markets argues for the need to preserve *consumer choice* and supporting *innovation* in financial products and systems.

The symposium highlighted the ways in which these objectives can be in tension with each other. In opening the symposium, Nicolas Retsinas framed the central question to be addressed as how to balance the desire to provide access to credit for low-wage workers with the need to control the level of risk associated with this lending. Belsky in his opening remarks noted the tension between protecting consumers while also preserving consumer choice and not overly restricting access to credit. The symposium discussion touched upon a variety of these types of tradeoffs. For example, expanding access to credit may come at the expense of affordability, as when small denomination loans or riskier lending expands, but at a price level that is not truly affordable for borrowers. More affordable loans may come at the expense of access, to the extent that limits on prices may make it difficult for lenders to offer these products. A common concern expressed in the symposium was that efforts to impose greater controls on financial markets may stifle innovation and its associated potential benefits. However, as Duncan Kennedy argues in his paper, these potential benefits need to be weighed against the potential losses in welfare that can occur from not placing limits on certain lending products and practices to which consumers are likely to fall prey.[8]

Ultimately, in deciding how to strengthen and reform the financial system, policy makers have to decide how to balance these interests. In the wake of the financial crisis, there is likely to be a tendency by regulators and lenders to place greater emphasis on the goal of reducing risks at the expense of the goal of ensuring access to credit. But several symposium participants pointed out that there has been a great deal learned since the early 1990s about how to safely lend to lower-income households. As financial markets recover from the crisis it will be important to not lose sight of these lessons and overly restrict credit beyond what is necessary to achieve a reasonable amount of lending risk.

The discussion at the symposium reflected different points of view about which criteria should take precedent and inevitability of conflicts among these criteria. Indeed many felt reducing the riskiness of lending and the suitability of consumer products were mutually reinforcing goals. However, many expressed the view that framing policy decisions in terms of their likely impact not just on a single intended goal but on other criteria was a constructive approach to evaluating alternative proposals.

Key Credit Market Failures Leading to the Financial Crisis

The financial crisis that erupted in 2008 has its roots in a broad range of factors, many of which are related to long-term trends in U.S. and global financial markets. In their paper, "Understanding the Boom and Bust in the Nonprime Mortgage Market," Belsky and Richardson present a narrative of the many forces that played a role in producing the crisis. The tremendous growth in nonprime lending—exceeding $4 trillion between 2000 and 2007—and the significant relaxation of traditional underwriting standards lies at the heart of the crisis. But the damage caused by the losses on these loans was greatly magnified by the development of complex financial derivatives, including credit default swaps and synthetic collateralized debt obligations. These financial products resulted in financial bets on

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8 Duncan Kennedy, "A Legal/Economic Analytic Framework for the Regulation of Consumer Credit Transactions."

nonprime loans that were many times the total value of outstanding loans. The risk in the financial system was further amplified by the low leverage ratios employed by many large financial institutions as a means of enhancing their profitability. When nonprime loans began to fail at high rates, the losses were compounded by the complex financial instruments and many large financial firms saw their thin capital quickly erased by these losses. In this way the failings of the mortgage market caused a broad, systemic financial crisis.

With an eye on how best to move forward from the crisis, discussion at the symposium did not attempt to assess the relative importance of the many factors that helped produce the financial crisis. Instead, the factors that were most commonly emphasized at the event were those that are most relevant to the debate about how best to reform the financial system. The summary presented below focuses on these factors.

Misaligned Incentives and Asymmetric Information

One of the most common themes of the discussion was the central importance in the crisis of misaligned incentives between financial institutions all along the chain from loan originators to the ultimate investors in securities derived from these loans. One fundamental problem raised was the conflict between the financial motivation of originators of loans and securities and the investors ultimately holding these assets. The nonprime lending market relied on an "originate to distribute" model, where the parties responsible for originating loans did not intend to retain any ownership interest in these loans or the resulting securities. Similarly, the firms packaging loans into mortgage-backed securities were also compensated based on the volume of securities sold without any stake in the long-term performance of these securities. With substantial profits from the fees earned from loan origination and security sales, these parties were incentivized to generate as many loans and securities as they could without regard to the long-term returns from these assets.

As housing prices soared in the 2000s, housing affordability deteriorated, threatening to reduce the flow of mortgage originations that was fueling significant profits for loan and security originators. Available evidence suggests that in response, the more exotic mortgage products described above were promoted and underwriting controls were substantially relaxed, allowing borrowers to qualify for loans with little or no documentation of income and assets and none of their own equity in the home. The quality of appraisals also appears to have diminished in many cases. In general, there was much more layering of risks in a single loan, rather than mitigating increased risk in one aspect of underwriting by more rigorous standards in other dimensions as was done in the 1990s to extend credit to riskier borrowers. As one industry observer noted, capital market products will only be as good as the underlying loans in these assets, so the underwriting of these mortgages was key to the resulting poor quality of these securities.

The shift in the orientation of lenders from one where they were carefully assessing borrower creditworthiness and preventing consumers from taking on excessive risks to one where borrowers were effectively encouraged to take on ever increasing levels of risk was truly remarkable. There was some sentiment that borrowers bear a degree of responsibility for their actions, but there was also a clear sense that lenders are better positioned than consumers both to understand lending risks and to place restrictions on the provision of credit.

Of course, the secondary market in the U.S. has played an important role in funding mortgages going back many decades, which raises the question about what changed in the 2000s to create these misaligned incentives. Prior to this time, the mortgage securities market was dominated by Fannie Mae, Freddie Mac, and Ginnie Mae. But in the mid-2000s, private-label securities came to account for a majority of the mortgage-backed securities market. Under this originate-to-distribute model, originators often had little capital at risk and their compensation was tied to volume far more than loan performance. Another layer of misaligned incentives that enabled the origination of poorly underwritten loans was between the rating agencies and investors. In the private label market, rating agencies are engaged by firms structuring securities to assess the risk of the proposed security. Investors rely on these ratings to determine the appropriateness of an investment. Many investors have obligations to limit the riskiness of their investments based on the investment grade assigned by a rating agency. As a result, rating agencies' determinations of the credit quality of securities carry a great deal of weight in the market. But since rating agencies are compensated by the firms offering securities for sale, there is an inherent misalignment of interests between rating agencies and the investors relying on their ratings. Investors may also have been blinded by the apparent rigor of advanced statistical modeling employed by the rating agencies to assess loan pools and other financial assets. It is now clear that investors relied too heavily on rating agencies and their risk-rating methodologies.

The faith placed in rating agencies by investors was critically important in allowing the riskiness of the underlying loans and securities to be hidden from view. But perhaps as important was that investors did not have access to the information needed to conduct an independent assessment of the risk of these assets, which could have acted as a check on the rating agencies' methodologies. In the language of economics, there was a significant problem of asymmetric information between investors and both loan originators and the firms pooling and structuring securities. This lack of transparency in these secondary market transactions was an important contributing factor in the development of the financial crisis.

Challenges for Consumer Choice

One fundamental cause of problems in the mortgage market also lay in the choices that were made by borrowers. This is not to imply that borrowers were solely, or even largely, at fault in making these choices. As discussed below, the circumstances under which these decisions were made all too often steered consumers toward choices that were not optimal either for consumers themselves or for society more broadly given the social consequences of these choices. As Susan Wachter noted, the failure of consumers to make good choices undermines the ability of the market to efficiently allocate capital.

A critically important factor affecting consumer choice has been the growing complexity in the mortgage options available. The emergence of nonprime lending beginning in the early 1990s introduced a much broader array of mortgage pricing than had previously been evident. Then, during the 2000s, the range of products offered expanded even further, including hybrid adjustable rate mortgages (ARMs), interest-only loans, and payment option ARMs. The use of piggyback second mortgages also became common as a way to obviate the need for mortgage insurance. Mortgages also more commonly included yield spread premiums and prepayment penalties, which borrowers appear to often have been not fully informed about.

This increasing complexity has made it more difficult for borrowers to compare prices for different mortgage options. Mortgage prices are ostensibly determined by borrower's credit scores and the terms of the loan, but with so many variables influencing the price it can be exceedingly difficult for borrowers to make "apples to apples" comparisons. This opacity of loan prices also creates the potential for lenders to take advantage of borrowers' inability to effectively compare loans, to charge prices that will yield excess profits.

Some loan terms may also be beyond most consumers' ability to adequately comprehend. A regulator cited research by the Federal Reserve Board that concluded that it may simply not be feasible to use consumer disclosures to effectively explain features such as yield spread premiums and effective annual percentage rates. Similar concerns apply to credit cards and payday loans, where borrowers may not truly comprehend the total cost of this credit.

There has also been a growing recognition of the cognitive biases inherent in the consumer decision making process that are likely exacerbated by the complexity of choices they face in mortgages and other financial products. One common bias is for consumers to weigh near term costs and benefits more highly than future repercussions of their choices. Loans with teaser rates or optional payments appeared less expensive to start with and allowed borrowers to buy more expensive homes than they would otherwise qualify for using a standard 30-year fixed-rate mortgage (FRM)—borrowers may have been drawn to these products because the near term benefits overshadow the longer term costs. When faced with complex choices, consumers may also tend to rely on simple metrics to guide their decision—such as whether the monthly payment is one they can afford. Finally, consumers also have a tendency to believe that the likelihood that they will personally experience a potential adverse outcome—such as a foreclosure—is less than the average risk.

Failures of the Regulatory System

Discussion at the symposium also frequently pointed to the failure of the regulatory system to prevent, identify, or respond to problems in financial market operations. The paper by Travis Plunkett provides a particularly thorough assessment of the current structure of the regulatory system and the nature of its failures in the recent crisis.[9] Overall, there were four primary categories of regulatory failure highlighted in the symposium. First, regulators generally subordinated consumer protection issues to concerns over financial institutions' safety and soundness. In his paper Plunkett argues that, in part, this subordination of consumer protection can be traced back to the fact that this role was not part of federal regulators' original missions as reflected in their authorizing statutes. These responsibilities instead were added over time to their duties through a variety of legislation, but have never become a key part of their organizational culture. Plunkett further argues that regulators' failure to act to protect consumer interests reflects an anti-regulatory bias predicated on the view that the risks of over-regulation are more severe than the risks of under-regulation.

Second, the balkanized structure of the regulatory system, with multiple agencies overseeing different sectors of the banking sector, resulted in weakened oversight of financial institutions. This structure may have led to some degree of regulatory capture, where agencies interpreted their mission as in part helping to support the institutions they supervised. With competing regulators financed by fees paid by the regulated, financial institutions can also "charter shop", providing an incentive for regulators to compete for members by providing more favorable regulatory regimes for their supervised institutions. This tendency was exemplified by federal regulators' efforts to preempt more stringent state regulations for their member institutions so that they could compete more effectively and bring greater standardization to their products and practices.

Third, there were significant holes in the finance industry's regulatory structure. Over time, nonbanks had come to account for a significant share of mortgage and other lending, including auto lending which was conducted increasingly by dealers as brokers. But these firms were subject to little federal oversight, as the regulators responsible for these

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[9] Travis Plunkett, "The Regulatory Structure and Consumer Credit Protections."

institutions, the FTC and the states, had limited supervisory capacity. Likewise, many of the most significant nonbank actors in the private label securities market—including investment banks, hedge funds, and ratings agencies—were also subject to little oversight or regulation. Yet, many of these institutions were at the heart of the financial crisis.

Finally, there was no regulatory focus on systemic risk as no one regulator was assessing the collective risk to the financial system. The holes in the regulator fabric also contributed greatly to increased systemic risk. The products that may have contributed especially to the crisis were collaterized debt obligations (CDOs) and credit default swaps (CDSs), which served to magnify the risks of nonprime lending and at the same time to mask the degree to which various counterparties were exposed to these risks. Without a regulator to track and oversee these activities, the degree of systemic risk went unchecked.

Taken together, Plunkett argues these failures of the regulatory system helped foster “a race to the bottom” in the mortgage market. Absent any checks on risky loan products and lax underwriting by firms outside of the regulatory system, this segment of the market grew rapidly. As these firms gained ground in the market, regulated institutions were drawn into these lending practices in an attempt to retain their market share and chase the higher returns offered in these markets. Regulators, in turn, in attempting to support the financial health of their segment of the industry, not only failed to stop this development but in effect supported it through their preemption of state regulations. Many participants in the symposium noted that the lack of a level playing field in the regulatory environment was a significant factor contributing to the crisis.

Failures in Responding to Mortgage Delinquencies

The growth in importance of private label securities as a source of mortgage capital also contributed to the challenges of responding to the mortgage market crisis, by creating impediments to resolving mortgage delinquencies. During the 1990s, both the GSEs and FHA had developed comprehensive loss mitigation programs for responding to mortgage delinquencies that were intended to provide a range of options for delegated servicers working with borrowers to resolve these problems. These programs provided servicers with clear guidelines about when various options should be offered to borrowers, and created a series of carrots and sticks to incentivize servicers to effectively implement these loss mitigation efforts. In contrast, the private label security market had no such standardization in agreements or unified ownership interest in these investments to develop such standardization in managing servicers. The nonprime market generally did not have well-developed loss mitigation programs and so were ill-prepared for the task of responding to the crisis. Patricia McCoy's paper provides an overview of a number of impediments to loan modifications that have been evident in the private label market's response to the Home Affordable Mortgage Program.[10] These include financial incentives for servicers to favor capitalization of arrearages and foreclosure, accounting rules that force immediate write-downs for permanent loan modifications, the presence of junior mortgages that threaten first-lien status if loans are modified, and, to a lesser extent, contractual limits placed on servicers' authority to modify loans through pooling and servicing agreements with investors. The challenges of mounting an effective response to the crisis have also highlighted the need to pay attention to impediments to workouts created by different market structures and regulatory regimes. In his paper, Howell Jackson argues that one of the impediments to loan workouts has been a lack of loan-level information on securitized loan pools.[11] Enhanced loan-level disclosure requirements could facilitate private loan renegotiations by removing uncertainty about the value of loans held in securitized pools and the terms on which comparable loans have been renegotiated or sold.

Moving Forward

The magnitude of the financial crisis made it clear that oversight of the financial system needed to be improved. The question that absorbed much of the symposium's energy was how the nation should move forward to reform the financial system both to prevent a recurrence of the financial crisis and to improve its capability to meet the nation's need for safe and affordable credit. Some of the broad issues discussed have effectively been settled with the passage of financial reform in July 2010. But while the broad contours of financial reform have seemingly been decided by the Dodd-Frank Act, there are innumerable decisions

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10 Patricia McCoy, "Barriers to Federal Home Mortgage Modification Efforts During the Financial Crisis."

11 Howell E. Jackson, "Loan-Level Disclosure in Securitization Transactions: A Problem with Three Dimensions."

left to be made by regulators in implementing the mandates of the Act. With shifting political fortunes for Republicans and Democrats, Congress may also revisit the choices made in this legislation. For these reasons, the ideas presented at the forum about the considerations that should be made in pursing change in the operation and oversight of the financial system can still help inform what will be an ongoing policy making process.

Three broad areas that fostered considerable discussion were: how best to improve protections for consumers, how to restructure the regulatory system, and how to improve transparency in both primary and secondary markets. The symposium also touched upon questions related to potential changes in the federal role in the housing market, the potential for reforming CRA, and reforms needed to improve the ability to respond when problems arise in mortgage markets.

Improving Consumer Protections

A wide range of approaches for improving consumer protections were considered, including enhancing consumer disclosures, expanding financial education, requiring default options, banning specific products, and imposing suitability standards. While consumer disclosures have been the primary means of protecting consumers, several participants argued that disclosures are not always sufficient, so other remedies should be employed. Which form of consumer protection is most appropriate depends on specific products and circumstances. In placing restrictions on the market, the other complicating factors that have to be weighed are the wide range of consumer needs and capabilities to understand and manage the risks that products suited to those needs present. "One size does not fit all" concerns apply not just to how to regulate specific products or practices but also how to best meet the needs of specific consumer groups.

In many respects, this point of view is reflected in the range of regulatory approaches adopted in the Dodd-Frank Act. The Act employs a variety of means to protect consumers, including bans on specific products, requirements for greater disclosures, and identifying a standard mortgage product that does not entail additional steps for ensuring consumer protection. Specific aspects of the Act relevant to the issues raised at the symposium are briefly indentified below. The most significant step toward enhancing consumer protections was the creation of the Consumer Finance Protection Bureau—which is discussed more below.

Enhancing Consumer Disclosures

Consumer disclosures have been one of the primary thrusts of existing efforts to protect consumers in financial transactions. In the wake of the crisis, a number of changes have been made to the key regulations governing consumer disclosures related to mortgages and other forms of consumer credit. These include changes to the Truth in Lending Act (TILA) to provide clearer and timelier information for borrowers about the terms and cost of their loans. There have also been significant changes to the Real Estate Settlement Practices Act (RESPA) with the goal of increasing transparency and enabling borrowers to get firm price quotes on loans and settlement services in order to comparison shop. But whether these enhanced disclosures will provide adequate protection for consumers is not yet known.

One thing that the crisis has demonstrated is that it is challenging to have effective disclosures. As discussed above, the complexity of financial choices often taxes consumers' ability to fully assess their options. Further, biases inherent in consumer decision making processes make them prone to poor choices involving uncertain future events. For disclosures to be effective, they must take into account both consumers' ability to understand the concepts needed to make wise decisions as well as their inherent biases in making these choices. This requires a much better understanding of consumer decision making.

For disclosures to be effective, they also need to provide consumers with the right and opportunity to act. This relates both to the timing of the disclosure (before or after a decision is made or an action taken) and to the information included. To account for consumer biases toward inaction, disclosures can also be designed to include information to help consumers identify other options or sources of assistance in making a decision. For example, the recently implemented CARD act updating the regulation of credit cards requires that monthly bills include contact information to obtain consumer credit counseling. Along these lines, one potential benefit of disclosures may be to help consumer advocates obtain key information about the choices their clients have made.

While properly structured disclosures were viewed by symposium participants as potentially valuable prongs of consumer protection efforts, there also was a clear sense that there were limits to the ability of disclosures to fully protect consumers. The Federal Reserve's research over the last decade into a variety of disclosures concluded that certain financial issues were too complex to be effectively handled through disclosure. These include yield spread premiums, double cycle billing, and payment allocations. The Dodd-Frank Act directly addresses some of these issues by defining a "qualified mortgage" that precludes a variety of these problematic loan terms. The qualified mortgage provides a safe harbor related to issues concerning securitization and foreclosure. In some cases where these loan terms are used, the Act also specifies additional safeguards that must be employed, such as mandatory counseling for borrowers. While the Dodd-Frank Act specified some general characteristics of the qualified mortgage, a specific definition will be defined as part of the rule-making process.

Expanding Financial Education

There was a greater difference of opinion regarding the potential importance of financial education as a remedy for poor consumer choices. A number of participants expressed the view that improving financial education should be an important priority moving forward given that a lack of financial knowledge was a contributing factor to the crisis. Because of an historical legacy of limited financial experience and rapid changes in financial markets, many families simply do not have the knowledge needed to navigate choices in today's market. In particular, emphasis was placed on the idea of enhancing financial education in schools to better prepare children for their responsibilities as adults. The idea of improved financial education also fit with a notion of financial citizenship where individuals' rights to access credit are balanced by their responsibilities in managing their finances.

However, others strongly expressed the view that there was only a limited role for education in protecting consumers. According to this view, there is an aspect of "blaming the victim" to suggest that consumers could have been better prepared to make appropriate choices. One advocate noted that financial education was arguably widely accessible over the last decade, and yet failed to prevent the consumer choices that lay at the bottom of the mortgage crisis. While beneficial, financial education may not be enough to prevent poor consumer choices in the future given the problems discussed above regarding the complexity of financial products and inherent consumer biases.

Supporting Savings by Low-Income Individuals

In considering the financial needs of low-income families, the symposium also touched upon the importance of enhancing support for savings efforts by low-income households as a means of improving their financial circumstances. One participant noted that experience from around the world amply demonstrates that it is possible for even very low-income individuals to save. Another participant commented that while long-term credit can be important for building assets, in general credit is not a pathway to prosperity, while savings are. Thus, there was recognition that policies to support savings would be an appropriate compliment to policies to enhance access to affordable credit.

Requiring Default Options

Building on findings from behavioral economics, a common approach for remedying consumer biases toward ill-advised choices is to establish a default option that consumers are automatically assigned to, based on the understanding that this choice is most likely to be beneficial for the average consumer. This arrangement is also referred to as an "opt-out" provision. In a default option model, borrowers can "opt-out" of the default option, but to do so they must take certain steps. The theory is that the action required to avoid the default option provides some protection that borrowers will fully consider their choice before selecting it. Alternatively, a system can be structured so that a choice that is less likely to be beneficial would require additional steps be taken before this option could be selected—a so-called opt-in provision.

Susan Woodward was a strong proponent for establishing an opt-out default option in the mortgage market for consumers to be offered a standard 30 year fixed-rate mortgage.[12] Individuals would still be able to choose alternative mortgage products, but might be required to obtain third-party counseling to ensure that the choice is appropriate for the individual.

[12] Susan Woodward, "The Future of the Capital Markets: Connecting Primary Consumer and Mortgage Credit Markets to Global Capital."

Woodward compared this arrangement to the requirements for counseling in FHA's reverse mortgage program, which she felt had worked well.

There were concerns expressed about opt-out provisions given that the needs of borrowers are quite heterogeneous. Adjustable-rate mortgages, for example, can be quite beneficial depending on how long a household plans on residing in the home, their expectations about future income growth, and the current level of interest rates. Imposing overly restrictive options and barriers to opting out may impose unnecessary costs.

However, overall, many participants expressed support for the idea of default options in specific circumstances as a means of dealing with products that are difficult for consumers to assess. But aside from the 30-year fixed rate mortgage other specific examples were not discussed.

By defining a qualified mortgage that provides safe harbor against other requirements and obligations, the Dodd-Frank Act employed a variant on this approach to defining a default option.

Banning Specific Products

A ban on specific products was identified as an option in cases where other remedies were unlikely to offer sufficient protection. The symposium did not identify any specific circumstances where bans would be the only or preferred means of protecting consumers. The Dodd-Frank Act does ban some specific products or terms (for example, it bans 'no-doc' or 'low-doc' loans) and also creates prohibitions that apply in specific circumstances, such as banning payments for specific loan terms where these would be paid to mortgage brokers.

Suitability

The idea of imposing a suitability standard for lenders in the mortgage market was raised a number of times as a means of responding to consumers' inability to make appropriate choices about financial products. Imposing a suitability standard on lenders could also remedy the problem of having lenders take advantage of borrowers' lack of knowledge to steer them toward more profitable products. A suitability standard would put the onus on lenders to provide consumers with an appropriate and fairly priced product. Such a standard could also address concerns about other remedies that impose restrictions on consumer choice. Given the diverse circumstances and needs of consumers, absolute restrictions on consumer choice could be a highly inefficient means of protecting specific classes of consumers. There was hesitation among symposium participants in recommending the adoption of suitability standards. One significant challenge in adopting this approach is determining rules governing what would be suitable for a given consumer. There were also concerns about the costs associated with imposing this standard. While the idea of a suitability standard has been floated for a number of years, there was a sense that not enough is known about exactly how such a standard would be implemented and what the repercussions would be. The Dodd-Frank Act did not introduce a suitability standard in relation to lenders interactions with borrowers.

Regulatory Reform

An assessment of both general principles and specific options for reforming and strengthening the regulatory system was a significant focus of the symposium.

Unifying the Regulatory Structure for Mortgage Lending

Many participants called for a more unified regulatory structure to ensure more consistent regulation and supervision of lenders lacking in the current byzantine structure. With the lack of a “level playing field” cited as a significant contributor to the crisis, bringing nonbank lenders under a consistent regulatory umbrella was discussed. A unified regulator, some argued, would also be less prone to regulatory capture and help prevent circumstances supporting a “race to the bottom” as occurred in the 2000s. Plunkett pointed out, however, that this may not be sufficient to ensure consumer protection, arguing the effort to combine consumer protection and safety and soundness in the same agencies was a failure. The Dodd-Frank Act addressed this concern in part through the elimination of the Office of Thrift Supervision and transferring its authorities to other regulators as a means of reducing the degree of overlap in the regulatory structure.

Also, in establishing more robust national regulatory standards, one regulator argued for the need to leave room for states to continue to have the option to establish stricter standards if they choose, arguing further that states played an important role in stepping up standards during a period when the federal government appeared to have abdicated this role. While there are efficiency gains from national standards, states could serve as a safety valve on federal efforts. The Dodd-Frank Act introduces new standards for determining when federal preemption of state laws will be allowed, and also makes clear that state laws which provide greater protections than federal law are not necessarily preempted. The Act also strengthens the states' role by giving attorneys general the authority to enforce the new law as well as regulations issued by the new Consumer Finance Protection Bureau.

Strengthening the Structure of Consumer Protection Regulation

There was little dispute over the need to strengthen the structure of consumer protection regulation. Plunkett's paper outlines three main options for restructuring the system:

- Create an independent Consumer Finance Protection Agency (CFPA) with this mission as a counterpoint to an agency whose mission is to ensure safety and soundness;
- Create a unified regulator for safety and soundness and consumer protection, with an internal division of responsibilities for these functions to ensure that one mission is not paramount to the other; and
- Create a consumer finance protection council with representatives of different regulatory agencies that will provide for a coordinated consumer protection effort.

There appeared to be support among some of the participants for an independent CFPA, although there were apprehensions that having an independent agency might tip the scales too heavily away from safety and soundness concerns. By the same token, the idea of locating the consumer protection mission within a unified regulator also responsible for safety and soundness raises concerns that consumer protection will once again be relegated to secondary importance. There are ways, however, that such an agency can be structured to ensure that the consumer protection mission is given adequate weight. There was little support for a consumer finance protection council, as interagency rulemaking is an unwieldy process that would be unlikely to result in any regulations being issued. As one advocate noted, such a group would represent a “coalition of the unwilling.” In addition, concerns were raised with the broad charge that might be given to the CFPA and the opportunity of various interests to influence outcomes in ways that could either dilute its efficacy or result in an overly aggressive posture that could stifle innovation—with the possibility that politics could cause it to swing from one pole to the other. With the establishment of the Consumer Finance Protection Bureau as an independent entity within the Federal Reserve by the Dodd-Frank Act, in many respects these concerns expressed at the symposium will frame how the efforts of this new bureau are assessed.

Closing Gaps in the Regulatory Structure

The need to bring the shadow banking system more firmly into the regulatory system was often mentioned, but specific aspects of how this should be done were not fleshed out. One specific point raised was the need for a regulator to have responsibility for overseeing systemic risk. John Campbell suggested that the Federal Reserve Bank was best suited to serve this role given the strong connection between their monetary policy role and systemic risk. Addressing systemic risk was a key focus of the Dodd-Frank Act, including the creation of a Financial Stability Oversight Council with responsibility for monitoring and managing systemic risk. The Council is chaired by the Secretary of the Treasury and includes as voting members the heads of eight other federal agencies involved in oversight of financial institutions and markets as well as an independent member with insurance expertise. The Act also established the authority for the orderly liquidation of firms deemed to pose systemic risk.

One issue that was discussed regarding oversight of secondary market participants was the need for bank and investment firms to hold capital against securities issued. Michael Lea’s paper examined this issue in detail by reviewing mortgage funding approaches in other countries that avoided the level of mortgage distress experienced in the U.S. The examples presented highlight some of the tradeoffs in requiring more “skin in the game” for secondary market participants. In most countries, capital requirements are instead imposed on borrowers through more stringent downpayment requirements for borrowers. However, higher downpayment requirements reduce the amount of financing available. Thus, higher capital standards include a trade off between reduced systemic risk and access to financing. The Dodd-Frank Act does establish credit retention requirements for securitizers, although many key details will be established in regulations to be determined.

Eugene Ludwig also touched upon proposals calling for changing capital standards in response to market conditions. Some reform proposals have called for higher capital standards to prevail during times of growth and lower standards during periods of economic contraction in an attempt to have credit policies that are countercyclical. Ludwig argued that regulators would be unlikely to lower capital standards during recessions out of fear for the safety and soundness of these institutions, so these countercyclical goals would be unlikely to be realized. Meanwhile, higher capital requirements would reduce lending volumes and contribute to lower economic growth.

Improving Transparency through Enhanced Information Disclosure

One of the failings of the mortgage market has been that lenders have an informational advantage over both borrowers and investors. A lack of information makes it difficult to assess the true risks of loans and whether borrowers are being offered credit at a fair price. Absent detailed information on loans and their performance over time, investors have had to rely on ratings agencies for an assessment of the risks inherent in securitized loan pools, which, in hindsight, provided overly optimistic assessments of the risks of these investments. As George MacCarthy noted, just as sunlight may be the best disinfectant, disclosures have the potential for remedying a host of ills in the mortgage market.

Two papers presented at the symposium explored issues relating to enhanced disclosure of information at the primary and secondary market levels. Allen Fishbein and Ren Essene provided a review of Home Mortgage Disclosure Act (HMDA), considering the potential for enhancements to the Act's disclosure requirements, while Howell Jackson's paper, mentioned earlier, examined options for loan-level disclosure in the context of securitization.[13]

[13] Allen Fishbein and Ren Essene, "The Home Mortgage Disclosure Act at Thirty-Five: Past History, Current Issues."

Through the public disclosure of information on all mortgage applications by covered institutions, HMDA has enabled “regulation from below,” where any member of the public can review a lender’s treatment of specific classes of borrowers by race/ethnicity, income, and geographic location. Given the lack of detailed information on borrower risk characteristics, HMDA has been more of a thermometer measuring activity in the market than a diagnostic tool. Nonetheless, HMDA has been a valuable tool for assessing the state of the market and helped to raise questions about patterns of lending activity in the 1990s and 2000s. It has led to strong efforts to increase lending to low and moderate income households and reduce discrimination. To make HMDA more useful as a diagnostic tool, reporting requirements would have to be expanded to include the key variables used in underwriting and measures of loan pricing. The Dodd-Frank Act does call for these types of improvements in HMDA reporting, including credit scores and property values to better assess risk, and points and fees and interest rate spreads relative to benchmark mortgage rates to better assess pricing.

In order to assess the actual costs of credit, it would also be necessary to gather information on loan performance over time. It was also noted that credit card, auto lending, and student lending lack a comparable public disclosure law, limiting the ability of public watchdogs to gain insight and influence over these areas of lending. The Dodd-Frank Act does attempt to address these concerns, for example calling for the SEC to adopt rules regarding the disclosure of information on assets backing securities.

Jackson notes that there are a number of proposals being developed for enhanced loan-level disclosures in the secondary market, including an endeavor by the securitization industry to restart this market, and proposals by the FDIC and the SEC to enhance their regulatory efforts. Jackson identifies three purposes that loan-level data on securitizations could serve. First, it would improve the pricing of securitization pools by providing potential investors with information needed to independently assess these pools. Second, it would provide information that could be useful for evaluating loan modification programs as a response to the crisis. Third, by including information on loan performance over time, these data could be used to assess loan pricing as a way to gauge whether borrowers are being treated fairly by lenders.

However, the expansion of loan-level disclosures in public data sets raises significant privacy concerns. These concerns are particularly evident with regard to HMDA data given the sensitive nature of the underwriting variables and the level of geographic detail provided in HMDA. These additional reporting requirements would impose additional costs on lenders, which would have to be weighed against the public benefits of these requirements.

Expanding disclosure requirements also raises questions about who should have access to these data if elements that could compromise privacy or provide competitive information are added to the information presently being disclosed. Concerns were raised about lenders facing reputational and legal risks pertaining to the release of such detailed information on lending practices. In the case of HMDA, public disclosure has allowed regulation from below, which has proved valuable. But this was in the context of an arguably weak regulatory regime. With a stronger regulatory system actively analyzing the data collected, there may not be as much need for public disclosure to allow regulation from below. Limiting disclosure to the regulator would help alleviate privacy concerns but would leave it up to regulators as to the vigor with which they pursue enforcement and prevent the public from having information to pressure regulators to do so if necessary. While the Dodd-Frank Act did specify additional reporting under HMDA, it did not resolve what information will be disclosed to the public.

As several participants noted, this highlights the fact that disclosure by itself is not sufficient to stem problems in the market. In fact, the discussion at the symposium suggested that disclosure by itself may not have been sufficient to have prevented the financial crisis. To be truly effective, disclosure needs to occur in conjunction with enhancements to the regulatory system to improve supervision and enforcement.

The Federal Role in Housing Policy Going Forward

Participants in the symposium noted that there are a variety of important roles for the government to play in the secondary market. The government is much better positioned than private firms to impose standardization on the market, which brings a number of efficiency gains. Governments support also enhances stability and liquidity. As this current crisis has clearly demonstrated, there is also a vital role for the government to provide catastrophic insurance and to serve as a backstop to the private market to keep capital flowing in times of crisis. Many argued that better mechanisms are needed, however, to have firms contribute for the cost of this catastrophic insurance. Finally, there is a role for government to support lending to low-income groups through cross-subsidization and by demonstrations of new products.

Reformulating the Community Reinvestment Act

The potential for reforming the Community Reinvestment Act was considered in a paper by Mark Willis. Willis describes CRA as an “aspirational law” establishing an obligation for banks to take positive steps to improve communities from which they take deposits. There are many reasons why CRA is ripe for being revamped. The role of banks in the financial system has changed in fundamental ways since CRA was first enacted in the 1970s, when the focus was on ensuring that banks reinvested in communities from which they took deposits. With the growth of the nonbank sector and the evolution of the banking sector to include megabanks and internet banks, there is less direct connection between the geography of deposit taking and lending activity. In addition, Willis describes how CRA tests have become more quantitative and mechanical since the last major revision of the regulations in 1995, which has reduced the incentives for banks to innovate or build working relationships with community organizations.

Updating CRA has been difficult, in part, because of its vague nature. It does not identify specific measures of desired activities or outcomes, leaving regulators to define the measures by which banks will be assessed. Without a clear sense of its goals, it is also difficult to train examiners to know how to assess banks’ activities.

In thinking about how to reform CRA, there are several key questions. One is how to better define the goals of the regulations so that regulators and financial institutions have a clearer sense of how to evaluate banks’ performance. It may also be appropriate to revisit CRA regulations on a more frequent and prescheduled basis so that information gained under different methods used to assess CRA performance can be fed back into improving these methods in a flexible response to changing industry and market conditions. Finally, given the changes in the structure of the finance industry there should be a reassessment of which institutions should be subject to CRA.

Improving Remedies for Mortgage Default

The paper by Patricia McCoy highlights the challenges that successive administrations have faced in attempting to find resolutions to the enormous tide of delinquent mortgages that will both help homeowners and stabilize the economy. The primary area for reform examined in the symposium is the potential for improving debtor remedies, discussed in the paper by Melissa Jacoby.[14] A key challenge of the existing debtor system is its complexity, which reduces the ability of consumers to exercise existing remedies and leads to specialization among lawyers that hinders consumers' ability to compare alternative remedies. Jacoby identifies several options for creating additional remedies that could be used to respond to the enormous wave of mortgage delinquencies. These include transplanting mortgagor protection rights found in federal bankruptcy law into state real property law. In addition, legal regimes other than chapter 13 could offer mortgage reinstatement rights on an installment basis, allowing consumers fighting foreclosure to deal with their mortgage problem without having to invoke a full-fledged bankruptcy proceeding. Along these lines, several participants argued that bankruptcy reform to allow the reduction of principle on first mortgages could have been a valuable tool for responding to the crisis, although it was recognized that politically this option is not tenable at present.

Conclusion

The proceedings of the symposium provided a wealth of information and ideas about the public interests at stake, factors leading to the crisis, and needed reforms to the financial system. With regard to the public interest, many argued that there was a pressing need to ensure the safety and soundness of the financial system and to capture the potentially

[14] Melissa Jacoby, "Making Debtor Remedies More Effective."

tremendous benefits of an efficient secondary market. While many also stressed that there are important equity interests in the outcomes and operations of the financial system particularly with regard to low-income and socially disadvantaged households, there was less agreement about how much to value these equity concerns. There are also inherent conflicts between the various public interests, particularly between concerns with equity and those of safety and soundness and economic efficiency. The challenge for policy makers—and regulators implementing the new financial reform legislation—is in choosing how to balance these competing public interests.

Several factors were mentioned by multiple participants as key to producing the crisis. These included misaligned incentives and asymmetric information between investors and loan originators and securitizers, a profound shift in orientation of lenders from limiting the degree of risk that borrowers could take on to encouraging ever riskier loans to maintain the flow of mortgages into the financial system, the failure by consumers to make appropriate choices regarding financial products given the complexity of these choices and inherent biases in consumer decision-making processes, and a general failure of the regulatory system to keep pace with evolving financial markets. There were also several features of a revamped regulatory system that were repeatedly mentioned. These included an elevation of responsibility for consumer protection, creation of a level regulatory playing field for all lenders through a more unified regulatory system, closing of critical holes in the regulatory fabric and federal oversight (particularly regarding secondary market institutions), and ensuring that there is a explicit focus on systemic risk. The important role of greater transparency in market operations through enhanced disclosures also was widely highlighted.

While the Dodd-Frank Act defined a broad blueprint for a revamped financial regulatory system, as always the details of implementation in pursuit of the identified goals will matter a great deal. There are a myriad of choices to be made in how to operationalize these broad goals. These choices will have important implications for the tradeoffs made between interests in safety and soundness, market efficiency, and equity concerns. There are particularly hard choices to be made regarding the tradeoffs inherent in seeking to expand access to affordable credit for lower-income or otherwise risky borrowers. The desire to provide greater consumer protection more generally may also come at the expense of the market's efficiency, both in terms of restrictions placed on consumer choice and the market's ability to innovate.

The policy debate on these issues reflects not just a difference in underlying values about which public interests are paramount, but also a fundamental uncertainty about the implications of different regulatory regimes for future economic development. The financial system is highly complex and intertwined with all aspects of the domestic and global economy. It is virtually impossible to anticipate the consequences of financial reform on the economic system. Yet, choices will have to be made. The proceedings of the symposium have served to highlight the fundamental issues that must be weighed and considered in plotting the course for financial reform.

Appendix A: Symposium Papers

Understanding the Boom and Bust in Nonprime Mortgage Lending
By Eric S. Belsky and Nela Richardson (Joint Center for Housing Studies of Harvard University)

Unfairness in Life and Lending: Credit and Low-Income Americans
By Tamara Draut and Jose Garcia (Demos)

How Should We Serve the Short-term Credit Needs of Low-Income Consumers?
By Rachel Schneider and Melissa Koide (Center for Financial Services Innovation)

Risk-Based Pricing: Problems, Possibilities, and Prospects (Published as: A Changing Credit Environment and Its Impact on Low-Income and Minority Borrowers and Communities)
By Peter Zorn (Freddie Mac) and Marsha Courchane (Charles River Associates)

The Future of the Capital Markets: Connecting Primary Consumer and Mortgage Credit Markets to Global Capital
By Susan Woodward (Sand Hill Econometrics)

Alternative Forms of Mortgage Finance: What Can We Learn From Other Countries?
By Michael Lea (San Diego State University)

Of Loan Modifications and Write-Downs (Published as: Barriers to Federal Home Mortgage Modification Efforts During the Financial Crisis)
By Pat McCoy (University of Connecticut School of Law)

The Home Mortgage Disclosure Act at Thirty-Five: Past History, Current Issues
By Allen Fishbein and Ren Essene (Federal Reserve Board)

Loan-Level Disclosure in Securitization Transactions: A Problem with Three Dimensions
By Howell E. Jackson (Harvard Law School)

Give Credit Where Credit Is Due: An Approach to Revamping CRA
By Mark Willis (NYU Furman Center)

How to Conceptualize the Public Interest in Financial Services (Published as: The Need for Government Intervention to Protect and Advance the Public Interest in Consumer and Mortgage Credit Markets)
By Eric S. Belsky (Joint Center for Housing Studies of Harvard University) and Susan Wachter (The Wharton School, University of Pennsylvania)

A Legal/Economic Analytic Framework for the Regulation of Consumer Credit Transactions

By Duncan Kennedy (Harvard Law School)

The Regulation of Consumer Financial Products: An Introductory Essay with a Case Study on Payday Lending
By John Campbell (Harvard University), Howell Jackson (Harvard Law School), Brigette Madrian (Harvard Kennedy School), and Peter Tufano (Harvard Business School)

The Regulatory Structure and Consumer Credit Protections
By Travis Plunkett (Consumer Federation of America)

Making Debtor Remedies More Effective
By Melissa Jacoby (University of North Carolina at Chapel Hill)

Behavioral Economics Insights Applied to Foreclosure Mitigation
By Sendhil Mullainathan (Harvard University), Antoinette Schoar (MIT Sloan School of Management), Eldar Shafir (Princeton University), and Piyush Tantia (Harvard University)

Appendix B: Symposium Participants

Frank S. Alexander, Emory Law School
Konrad Alt, Promontory Financial Group
Pamela Baldwin, Joint Center for Housing Studies of Harvard University
Michael J. Barry, Consumer Federation of America
Eric S. Belsky, Joint Center for Housing Studies of Harvard University
Daniel Bergstresser, Harvard Business School
David W. Berson, The PMI Group
Suzanne Boas, Consumer Credit Counseling Service
Dr. Raphael W. Bostic, U.S. Department of Housing and Urban Development (HUD)
John E. Bowman, Office of Thrift Supervision
Sandy Braunstein, Federal Reserve Board
Amy Brown, Ford Foundation
Lynn E. Browne, Federal Reserve Bank of Boston
Robert Buckley, The Rockefeller Foundation
Barrett Burns, VantageScore Solutions LLC
Mike Calhoun, Center for Responsible Lending
John Y. Campbell, Harvard University
Glenn Canner, Board of Governors of the Federal Reserve System
Prabal Chakrabarti, Federal Reserve Bank of Boston
Marsha Courchane, Charles River Associates
Lisa Davis, Ford Foundation
Benjamin de La Pena, The Rockefeller Foundation
Frank DeGiovanni, Ford Foundation
Tino Diaz, National Association of Hispanic Real Estate Professionals
Tamara Draut, Demos
Keith Ernst, Center for Responsible Lending
Ren Essene, Federal Reserve Board
Allen Fishbein, Federal Reserve Board
Michael Fratantoni, Mortgage Bankers Association
Jose Garcia, Demos
Edward Golding, Freddie Mac
Ramon Gomez, JP Morgan Chase; Home Finance
Martin J. Gruenberg, Federal Deposit Insurance Corporation (FDIC)
Jeffery Hayward, Fannie Mae
Colleen Hernandez, Homeownership Preservation Foundation (HPF)
Richard M. Hisey, AARP Financial Inc.
Edward A. Hjerpe, Federal Home Loan Bank of Boston
Victoria Ivashina, Harvard Business School
Howell E. Jackson, Harvard Law School
Melissa B. Jacoby, University of North Carolina at Chapel Hill
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Ellen Lazar, FDIC
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Christopher Malloy, Harvard Business School
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Anne Segrest McCulloch, Fannie Mae
Edmund Mierzwinski, U.S. PIRG
George P. Miller, AUSPEX LLC
Haydeé Moreno, Self-Help
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Nicolas P. Retsinas, Joint Center for Housing Studies of Harvard University
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Barbara A. Ryan, Federal Deposit Insurance Corporation (FDIC)
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Rachel Schneider, Center for Financial Services Innovation
Arthur Segel, Harvard Business School
James Segel, Financial Services Committee
Ellen Seidman, New America Foundation
Harold Simon, National Housing Institute
Joseph A. Smith, North Carolina Office of the Commissioner of Banks
Tom Stanton, Johns Hopkins University
Eric Stein, Department of the Treasury
Piyush Tantia, ideas42, IQSS, Harvard University
John Taylor, National Community Reinvestment Coalition.
Terry Theologides, First American Information Solutions Company
Robert Tsien, Freddie Mac
Peter Tufano, Harvard Business School
Susan Wachter, The Wharton School, University of Pennsylvania
Ken Wade, NeighborWorks America
Sarah Wartell, Center for American Progress
Mark Willis, Furman Center New York University
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