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Hearing on Consumer Credit and Debt: The Role of the Federal Trade Commission in Protecting the Public

Written Testimony

of

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It is an honor to appear today before this Committee. Thank you for the opportunity to share some thoughts on the consumer protection role of the Federal Trade Commission in the area of consumer finance. My name is Christopher Peterson and I am a law professor at the University of Utah where I teach commercial and consumer law classes. I commend you, Mr. Chairman, Ranking Member Radanovich, and other members of the Subcommittee for organizing this hearing and for providing an opportunity to discuss this important and timely national issue.

As you know, our country is currently suffering from the worst financial crisis since the Great Depression. This crisis has its origins in the subprime and alternative home mortgages that were packaged into securities and used as references in risky derivative transactions. While in past years, consumer advocates have criticized financial services companies for engaging in predatory lending, it has become increasingly clear that something more complex is responsible for our current predicament. Rather, "*predatory structured finance*" has simultaneously undermined the well-being of two separate groups: homeowners that relied on unrealistic subprime and alternative mortgage loans and investors that purchased securities drawn from or in reference to these loans.[1] By linking two distinct classes of sometimes unsophisticated consumers, employees at a series of financial intermediary companies had the opportunity to extract lucrative fees, commissions, and bonuses. It is now apparent that many financial services companies held little regard for whether borrowers could successfully repay their mortgage loans or whether investments drawn from those loans would pay out on time.

[1] Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185 (2007), *available at:* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929118.

Unfortunately, federal financial regulators, including the F.T.C., were caught flat-footed by the increasing complexity and stunning breakdown in market efficacy associated with the subprime mortgage crisis. The American public is anxious for reform of consumer financial services both to stabilize our economy and also to promote fairer, more transparent, and safer use of credit. In my testimony I will discuss (1) why existing Federal Trade Commission (F.T.C.) regulations did not prevent the subprime mortgage crisis; (2) the barriers to more effective F.T.C. regulations and the problem of fragmented federal consumer finance regulation; and (3) the need for comprehensive reform in order to stabilize financial markets and restore consumer confidence.

I. Existing Federal Trade Commission Credit Regulations and Enforcement Are Insufficient to Deter Predatory Structured Finance

While the foreclosure crisis was caused by a complex set of factors, the core problem was that subprime market mortgage loan brokers and originators had fundamentally inefficient incentives. Once a market for private label residential mortgage backed securities developed, these companies obtained compensation from closing costs and the proceeds of selling loans to secondary market participants, who in turn, sold them to investors. Generally speaking, the more loans originated the more money the broker or originator made. Similarly, other things being equal, the larger the loan, the higher the commissions, closing costs, and sale proceeds that a broker or originator earned. These simple facts created strong short term incentives for brokers and originators to cut corners in the underwriting process—leading to a dangerous and sometimes fraudulent disparity between company policies and company practices. It also created an incentive for brokers and originators to encourage consumers to borrow more money than

they could afford. And, in order to facilitate as many loans with the largest principal possible a large volume of loans, brokers and originators had an incentive to put tremendous pressure on appraisers to value homes at higher and higher prices. It is likely that this is the process that inflated the home value bubble.

For its part, the F.T.C. has enforcement responsibilities relating to four major titles of the Consumer Credit Protection Act (including Equal Credit Opportunity, Fair Credit Reporting, Fair Debt Collection, and Truth-in-Lending), plus its responsibilities for preventing unfair and deceptive trade practices under the Federal Trade Commission Act. Unfortunately, none of these statutes, nor the F.T.C.'s deception and unfairness regulations have provided any meaningful hindrance to predatory structured finance of home mortgage loans.

A. F.T.C. Responsibilities under the Consumer Credit Protection Act

The Equal Credit Opportunity Act was adopted to facilitate equal access to credit for groups that had been denied loans in much of American history. While this is, of course, an indispensible statute, the current crisis is associated with too much unaffordable credit, rather than the discriminatory denial of credit to those that qualify. So far, neither the F.T.C. nor other public or private litigants have been able to use the ECOA to prevent socially destructive subprime or non-amortizing loans to prime borrows.

Moreover, the Fair Credit Reporting Act does not give the F.T.C. tools that would change the fundamentally misaligned incentives of brokers and lenders that originate mortgages for resale as private-label residential mortgage backed securities. As you know, this statute provides consumers rights to help them maintain accuracy in credit reports. One might have hoped that maintaining accurate credit reports would have helped a stable preponderance of consumers

obtain less expensive loans with repayment terms more resistant to foreclosure—but this has not been the case. Many of the loans facilitating the foreclosure crisis have such unrealistic repayment terms or were made to those that could not realistically repay them, that more accurate credit reporting information would not have averted default. Indeed many of the borrowers that have defaulted on non-amortizing mortgage loans with introductory interest rates were prime borrowers with solid credit histories. Mortgage brokerages, lenders, investment banks, bond insurance companies, hedge funds, and their employees developed structured finance techniques and corporate compensation plans that allowed them to handsomely profit irrespective of the propensity of borrowers to repay.

The Fair Debt Collection Practices Act was not designed to prevent formation of ill-advised mortgage loans. While the statute admirably attempts to prevent abusive and deceptive collection by third party debt collectors, mortgage loan servicing companies are exempt from the statute provided that they obtain servicing rights on a loan prior to default. Moreover, even if debt collection remedies could deter formation of ill-advised loans, the F.T.C. lacks the resources to bring a sufficient number of cases to established meaningful deterrence. Since 1999, the F.T.C. has brought 21 lawsuits against debt collectors for violating the FDCPA.[2] While these suits are an important national service, the F.T.C. simply has nowhere near the sort of resources needed to create meaningful deterrence for widespread misbehavior of mortgage loan servicers.

The Federal Trade Commission also has enforcement responsibly under the Truth in Lending Act for non-depository institutions. The Truth in Lending Act was designed to assist consumers in shopping for the most advantageous credit. However, time has demonstrated that

[2] Prepared Statement of the Federal Trade Commission on "Consumer Protection and the Credit Crisis" before the Senate Committee on Commerce, Science and Transportation, February 26, 2009, at 12.

the disclosure approach to addressing credit abuses has only very limited usefulness—at least as it is currently conceived. Consumers are presented with information they do not understand, that does not present much of the most important information at a time when the borrower is already committed to a transaction. TILA's damage awards have not been updated to reflect inflation in generations. Truth in Lending information is presented separately and at different times from closing cost information provided under the Real Estate Settlement Procedures Act. And, perhaps most ironically, the statute that purports to promote truth in consumer finance does not even apply to the businesses that most commonly actually *speak* to mortgage loan applicants: mortgage brokers.

B. F.T.C. Responsibilities Under the Federal Trade Commission Act's Deceptive and Unfair Trade Practices Prohibition

At the core of the Federal Trade Commission's consumer protection mission is its responsibility to identify and prevent deceptive trade practices under the Federal Trade Commission Act. Here, the F.T.C. has currently only adopted two regulations which might have provided some deterrence to predatory structured finance of home mortgages. Most notably, in 1975 the F.T.C. adopted its Preservation of Claims and Defenses Regulation, more commonly known as the F.T.C. Holder-in-Due-Course Notice Rule. Under traditional state commercial law, lenders and their assignees could use the longstanding holder-in-due-course doctrine to "cleanse" assigned negotiable instruments of a borrower's claims and defenses against the original lender. But, under the F.T.C.'s regulation, where a loan finances consumer goods or services, it is a deceptive trade practice to assign a loan contract that does not include contractual language eliminating the negotiability of the document memorializing the agreement. This prevents the

secondary market owners of loans financing consumer goods and services from asserting the holder-in-due-course defense. Unfortunately, with the possible exception of home improvement loans, the F.T.C. has never applied the holder-notice rule to home mortgages. Now foreclosing trusts that own home mortgages loans on behalf of investors routinely assert the holder-in-due-course doctrine against homeowners attempting to show fraud or other consumer protection law violations in the origination of their loan. The result: even if a broker or lender committed fraud in originating the loan, this fact will generally be irrelevant in a foreclosure proceeding. Although the home mortgage market now has many of the characteristics of the retail installment and automobile finance markets that justified the original holder notice rule, the F.T.C. has not attempted to expand the scope of this regulation. Currently, secondary market purchasers of home mortgage loans have limited or no potential liability for malfeasance of brokers and originators—and thus have little incentive to police the behavior of their business parners.

Second, in 1984 the Federal Trade Commission adopted a "Credit Practices Rule" which bans the use of a few credit contract terms deemed unfair or deceptive. In particular, the regulation prohibits confession of judgment clauses, waiver of statutory borrower exemption laws, assignments of wages, non-possessory security interests in some household goods, and pyramiding of late fees. While these are surely useful rules, the credit industry has long since found effective substitutes. For example, mandatory, binding, pre-dispute arbitration clauses in boiler plate contracts now force many borrowers into expensive, secret, private justice systems that are designed to favor creditors. Similarly, in many states "payday" loan companies use a borrower's personal check in offering loans with average interest rates of about 450% per annum—quite effectively substituting for a wage assignment. With respect to the foreclosure

crisis, the F.T.C. has not updated its credit practices rule to ban any of the mortgage loan terms and compensation systems that caused the creation of so many millions of ill-advised loans.

II. The Federal Trade Commission is Hamstrung by a Byzantine Rulemaking Procedure and has Suffered From Passive Leadership on Finance Issues

In the de-regulatory spirit of the early 1980s Congress amended the Federal Trade Commission Act to make it more difficult for the F.T.C. to adopt new regulations than most other administrative agencies. Section 15 U.S.C. § 57a requires that the F.T.C. engage in a more extensive series of proposed rule-making notices than other agencies. The F.T.C. is also required to provide hearings with cross examination rights to interested parties and it is required to conduct both preliminary and final cost benefit analyses of any proposed rule. Since these procedural hurdles were erected, the Federal Trade Commission has not consistently responded to rapid changes in consumer financial services. Particularly in the complex and evolving mortgage securitization markets, the F.T.C.'s cumbersome rulemaking process likely hindered an effective response to predatory structured finance.

Furthermore, a discussion of the F.T.C.'s ability to respond to consumer finance challenges cannot be complete without pointing to the fragmented federal consumer finance regulatory system. The F.T.C. shares consumer finance regulatory responsibility with Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Federal Finance Agency (formerly Office of Federal Housing Enterprise Oversight), Housing and Urban Development the Securities Exchange Commission, Federal Bureau of Investigation, and the Justice Department. I am aware of no other western democracy

that so aggressively pits administrative agencies against each other on such an important sector of its economy.

In recent years, there can be no serious doubt that the result of these complex overlapping jurisdictions has been a race to the bottom in terms of consumer protection. Capital has flowed into institutions that are overseen by the least aggressive federal regulators. Because this hearing is on the subject of the Federal Trade Commission, it is within the scope of today's subject matter to share my view that the F.T.C., while limited in resources and authority, has been a more aggressive enforcer of consumer protection law than the Office of the Comptroller, the Office of Thrift Supervision, or the Federal Reserve Board of Governors. Indeed the O.C.C. and O.T.S., in particular have actively sought to prevent the application of state consumer protection law to the institutions they charter, and have replaced those state laws with minimal regulation and half-hearted enforcement.

This being said, it is clear the F.T.C. could have done more to protect consumers and stabilize the economy. By virtually all accounts, two of the most problematic actors in originating mortgage loans have been independent, non-depository mortgage brokers and real estate appraisers. Neither of these types of businesses fall outside the scope of F.T.C. jurisdiction. And yet, the F.T.C. has not attempted to impose new regulations on deceptive practices in mortgage loan brokering, nor deceptive practices in real estate appraisals. Even with the procedural hurdles the F.T.C. faces in adopting new regulations, one would hope that sufficient evidence of mortgage broker and appraiser malfeasance is now available to facilitate some new regulation.

III. Comprehensive Reform is Needed to Stabilize the Consumer Financial Markets, Restore Consumer Confidence, and Protect Financial Institutions from Themselves

The legal and commercial systems that facilitated securitization of subprime and alternative mortgage loans were extremely adept at generating high volume. But, it did not reliably provide high quality services to consumers and investors. This problem stems from the legal incentives actors in the system operate under. The one uniform feature of residential mortgage law is its failure to recognize and account for the complex financial innovations that have facilitated securitization structures. Most of the relevant consumer protection law, including the Truth in Lending Act (1968), the Fair Debt Collection Practices Act (1977), the Equal Credit Opportunity Act (1974), the Fair Housing Act (1968), and the Federal Trade Commission's holder in due course notice rule (1975) all preceded widespread private label securitization of mortgage loans by over a decade. While this time frame is not meaningful in itself, it hints at a fundamental structural problem in the law. The authors of these laws wrote definitions and rules that are poorly adapted to the current marketplace. Left without a meaningful vocabulary amenable to regulation of securitized consumer loans, courts and regulators—including the Federal Trade Commission—have struggled to crowbar satisfactory policy outcomes out of legal rules and concepts which only vaguely relate to the commercial reality they purport to govern.

Taking one of many possible examples, the Truth in Lending Act and the Home Ownership and Equity Protection Act only govern the behavior of "creditors". This word suggests a unitary notion of a single individual or business that solicits, documents, and funds a loan. A creditor is currently defined as "the person to whom the debt arising from the consumer

credit transaction is initially payable on the face of the evidence of indebtedness."[3] This definition is important since the private cause of action creating the possibility of liability under the act extends only to "any creditor who fails to comply" with the Act's requirements.[4] While this definition resonates with the notion of a lender as we commonly think of it, this notion that became entirely inconsistent with American reality in the past ten years. In the vast majority of subprime and alternative home mortgage loans, most of the actual tasks associated with origination of the loan, including especially face-to-face communication with the borrower, are conducted by a mortgage loan broker. Because brokers usually do not fund the loan, they are not the party to whom the loan is initially payable. The absurd result is that the federal statute which purports to promote useful and accurate disclosure of credit prices, does not govern the business or individual that actually *speaks* to a mortgage applicant. Rather, liability for the statute is confined to errors in the complex paperwork that many consumers have difficulty reading and are typically ignored in hurried loan closings long after borrowers arrive at decision on which broker and/or lender to use.

While this is only one example, more absurdities abound both in mortgage lending and in other areas of consumer finance:

- The Fair Debt Collection Practices Act often usually does not apply to mortgage servicers or even credit card companies;

- Banks and Thrifts can lawfully charge interest rates far in excess of the 45% per annum *per se* evidentiary trigger in the Consumer Credit Protection Act's criminal loan sharking law;

- The anti-kick back rule in the Real Estate Settlement Procedures Act does not prevent mortgage brokers from receiving a commission for selling a loan with a

[3] 15 U.S.C. § 1602(f).
[4] 15 U.S.C. § 1640(a).

higher interest rates than a borrower qualifies for based on the lender's own underwriting guidelines;

- The statutory damage awards for successful consumer litigants under most federal Consumer Credit Protection Act remedial provisions have not been adjusted for inflation in over forty years;

- The Truth in Lending Act's scope provisions exclude application of the act to non-residential loans of more than $25,000—precluding the application of the statute to loans for most family cars;

- Depository institutions can make triple-digit-interest rate loans through Automatic Teller Machines, without informing the borrower of an interest rate—or even that the borrower is obtaining a loan;

- Entire segments of the consumer finance industry have opted out of the civil justice system by burying small, arbitration clauses in their boilerplate contracts; and,

- The wealthiest country on earth has allowed its financial system to create numbers of financial refugees one would normally associate with a civil war or massive natural disaster.

It is against this backdrop that the F.T.C.'s performance and future abilities must be considered. In recent years, the F.T.C.'s consumer finance efforts have essentially focused on (1) a relatively small number of enforcement cases; (2) some limited consumer education conducted primarily through the agency's web page and some outreach in the press; and, (3) some interesting empirical research and policy development. While these efforts are doubtlessly well meaning—and perhaps the best the agency could have accomplished given its political, resource, and rulemaking constraints—they are not the sort of policies that have any serious hope of reforming American consumer finance. For example, while some estimate up to *six million* home foreclosures in the near future, the F.T.C. was only able to bring a total of *six* foreclosure rescue

scam cases in the past year.[5] When compared to the magnitude of problematic consumer finance in the American economy, the Federal Trade Commission will not be able to help Americans without dramatic change directed from Congress.

If the federal government is going to succeed in comprehensively modernizing and reforming our consumer finance laws, it is likely that one of two plausible paths must be followed. First, Congress could attempt to pass a large, highly technical, and controversial bill that implements the needed changes across nearly a dozen different statutes, through many committees, and over the objection of powerful financial services industry advocates. Or second, Congress could pass the heavy and more technical lifting on such reforms to an administrative agency. The problem with the latter approach is that there is currently no agency both capable of and likely to handle the consumer protection challenges we face. Housing and Urban Development's exclusive focus on housing is too narrow to handle the integrated complexities of real estate and non-real estate related consumer finance. The Federal Reserve has technical proficiency, but also has a longstanding culture of approaching consumer problems from a banker's perspective. The political independence that insulates the Federal Reserve Governors from politics serves us well on monetary policy, but would temper the ability of Congress to encourage action on questions of consumer fairness and justice. Moreover, Congress *already* gave the Fed the authority to adopt many of the rules that might have prevented the mortgage crisis in the Home Ownership and Equity Protection Act of 1994, but the Governors chose not to meaningfully exercise that power. The O.C.C. and the O.T.S. have less expertise, fewer resources, and weaker consumer protection track records than the Federal Reserve. Of all the

[5] Prepared Statement of the Federal Trade Commission on "Consumer Protection and the Credit Crisis" before the Senate Committee on Commerce, Science and Transportation, February 26, 2009, at 14.

currently existing agencies, the Federal Trade Commission probably would hit closest to the mark—but might do so at the expense of focus on the F.T.C.'s many other important responsibilities, such as antitrust, advertising, privacy, product quality, and identity protection. The current crisis suggests that it may be time to seriously consider proposals calling for a new regulatory authority tasked with an exclusive focus on financial consumer protection.