Statement of

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Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Jim Sivon, and I am a partner in the Washington, D.C. law firm of Barnett Sivon & Natter, PC. Our firm specializes in financial services law and regulation. I appreciate the opportunity to appear today to discuss consumer protection in the financial services industry following the U.S. Supreme Court's decision in *Watters v. Wachovia Bank*

The decision in the *Watters v. Wachovia Bank* case is the latest in a long line of decisions by the U.S. Supreme Court interpreting the National Bank Act. As a whole, those decisions have insulated national banks from state interference with the conduct of their banking business. This has permitted the development of our national banking system as envisioned by its authors, President Lincoln and his Treasury Secretary, Salmon P. Chase. President Lincoln and Secretary Chase foresaw how a system of national banks could contribute to the growth and development of our nation. Today, almost 145 years since the passage of the National Bank Act, we have a system of healthy and financially strong national banks that serve as an important source of credit and opportunity for consumers and businesses.

At the same time, it is important that federally chartered banks and thrifts are responsive to consumers and treat them fairly. In order to highlight some of the consumer protection issues facing national banks and federal thrifts following the decision in *Watters v. Wachovia*, I have organized my statement chronologically from the beginning of a consumer credit transaction to the end of the transaction.

<u>Financial Literacy</u>

At the beginning of a credit transaction, the best protected consumer is an educated consumer; that is, a consumer who is financially literate. Financial literacy has been the focus of a significant amount of attention in recent years. Many financial services firms and financial regulators have made a commitment to financial literacy. Citigroup, for example, has committed over $200 million over a 10 year period to support financial education programs and organizations around the world. The FDIC also has an excellent financial literacy program called Money Smart that has reached over 600,000 consumers.

Yet, financial literacy surveys by the Jump$tart Coalition for Personal Financial Literacy indicate that much more needs to be done. The Coalition has tested the financial literacy of high school students annually since 1997. Throughout that period, test scores have hovered in the low- to mid- 50 percent range. These surveys also show a gap in financial literacy between minority and non-minority students. In the most recent survey, white students scored an average of 55 percent on the test, while African-American students scored 44.7 percent, and Hispanics scored 46.8 percent.

In my opinion, the solution to this challenge is to incorporate financial literacy into the curriculum of our public school systems. This would ensure that young men and women receive financial literacy training before they become active consumers of financial products and services. A few states have modified their curriculum to require financial literacy to be taught in their public school systems. The Federal Government and the financial services industry should work with the states to make this opportunity available in all states.

Disclosure

The disclosure of the key terms and conditions of a financial product or service is the next step in the credit process, and is an important consumer safeguard. Generally, Congress and financial regulators have relied upon disclosure requirements to protect consumers rather than restrictions on price and product terms and conditions. The Truth in Lending Act, for example, requires creditors who make consumer loans to disclose all financial charges in dollar and annual percentage terms, but does not dictate rates or conditions. I believe that this is an appropriate policy. It stimulates competition and innovation to the benefit of consumers.

However, in order for disclosures to work properly, they must be clear and understandable. As financial products and services have become more complex, disclosure requirements may have reached a point where consumers are more overwhelmed than informed. The volume of paper in a typical residential real estate closing, for example, is daunting. Some disclosures also may be counterproductive. Just last week, the American Bankruptcy Institute and the Ford Foundation released a study that found that credit card disclosures designed to prevent overspending may have the opposite effect on some consumers.

Ensuring that disclosures are informative, and not overwhelming, is a challenge. The federal banking agencies have started to make use of consumer testing and focus groups in the development of new model disclosure forms. Such testing should continue, and disclosures that are unnecessary or counterproductive should be eliminated. Congress also should resist the temptation to mandate disclosure terms, type size or other details. Detailed statutes typically result in lengthy detailed regulations. More general statutory guidance gives regulators the flexibility to craft and revise disclosures to address new products and meet the changing needs of consumers.

Uniform National Protections

After selecting a particular financial product or service, a consumer is concerned about the protections that apply to that product or service. We have a national consumer credit system, but all consumers do not enjoy the same level of protection.

The recent problems in the mortgage market illustrate the limitations of the current system. The federal banking agencies have responded to the problems in the mortgage market with two separate interagency advisories on appropriate lending practices and policies. These advisories, however, apply only to lenders that are subject to federal supervision and regulation, not to state licensed lenders. While efforts are underway within the states to impose similar requirements on state licensed lenders, nothing guarantees that all states will adopt the same or even similar requirements. As a result, consumers that obtain a loan from a federally regulated lender receive one level of protection, and consumers who receive a loan from a state lender receive a different level of protection or no protection at all. This not only deprives consumers of comparable protections, but allows institutions to engage in regulatory arbitrage based upon different consumer protection requirements.

Consumers of a financial product or service should receive the same protection, regardless of the type of lender that provides the product or service or the jurisdiction in which the product or service is delivered. Uniform, national consumer protection requirements would meet this goal.

I recognize that individual states may wish to impose additional requirements on the lenders for local reasons. However, history has shown that some laws enacted in the name of consumer protection unintentionally have caused financial losses to insured institutions, and thereby reduced the availability of credit.[1] Federal preemption of such laws protect the fiscal integrity of national banks and federal thrifts, and the supply of credit.

On the other hand, preemption should not create a void in consumer protection. The protections afforded consumers who obtain products and services from national banks and federal thrifts should be robust. Today, national banks and federal thrifts are subject to a number of federal consumer protection statues that protect consumers, including the Truth in Lending Act, the Equal Credit Opportunity Act, and the Fair Housing Act. Yet, we may have reached a point where additional safeguards are appropriate. Both the Federal Trade Commission Act

[1] The nation's experience with due on sale clauses is an example of state consumer protection laws that have unintended consequences. After a number of states prohibited lenders from enforcing such clauses in the wake of record high interest rates of the late 1970s and early 1980s, the economic condition of mortgage lenders worsened, and the number of insolvencies increased. Eventually, the Federal Home Loan Bank Board published a regulation preempting state laws that prohibited the enforcement of due on sale clauses, and the U.S. Supreme Court upheld the preemptive effect of the regulation in the case of *Fidelity Federal Savings & Loan Association v. de la Cuesta*, 102 S.Ct. 3014 (1982).

("FTC Act") and the Home Ownership Equity Protection Act ("HOEPA") provide the federal banking agencies with the authority to define and prohibit acts or practices by depository institutions that are unfair or abusive, whether in the mortgage area (HOEPA) or with respect to any service (FTC Act).

HOEPA

HOEPA was enacted in 1994 in response to Congressional concerns over "reverse redlining." HOEPA establishes a class of residential mortgage loans that are subject to special disclosures and other requirements. A HOEPA loan is defined as a closed-end, non-purchase mortgage loan, secured by a consumer's principal residence, that has an annual percentage rate in excess of 10 percent above Treasury securities with a comparable maturity, or that has total fees and points that exceed the greater of $400 or 8 percent of the total loan amount. The Federal Reserve Board has the authority to adjust these triggers, within certain parameters. The current triggers are 8 percent above Treasuries for a first loan, and 10 percent above Treasuries for a second loan, and the fee trigger has been raised to the greatest of 8 percent of the loan or $547 to reflect inflation.[2]

HOEPA loans are subject to extra disclosure requirements, which must be made at least 3 days prior to the loan closing. The Act also imposes substantive restrictions on these loans, including prohibitions on prepayment penalties (unless certain conditions are met),[3] penalty interest rates in the event of a default, balloon payments for short-term loans, and negative amortization features. Further, a lender may not engage in a "pattern or practice" of extending credit through HOEPA loans without regard to the consumers' repayment ability, including current and expected income, obligations, and employment.

[2] 12 C.F.R. § 226.32 and Supplement I.

[3] The loan may include a prepayment penalty if certain conditions are met and if the penalty does not apply 5 years after the date of the loan origination.

While HOEPA is primarily concerned with HOEPA loans, it also providesthe Federal Reserve Board with the authority to proscribe certain practices with regard to <u>all</u> mortgage loans.[4] This legislation gives the Federal Reserve Board the power to regulate any act or practice that the Board determines is "unfair, deceptive, or designed to evade the provisions of [HOEPA]." With respect to re-financing transactions, the Board's authority also includes the ability to prohibit any act or practice that it determines is "abusive" or that is "otherwise not in the interest of the borrower."

The Board initially issued regulations implementing HOEPA in 1995.[5] In 2001, the Board amended these regulations to broaden the coverage of the Act and to prohibit certain practices that the Board determined were unfair, deceptive, or designed to evade HOEPA.[6] For example, the regulations state that a creditor may not restructure a HOEPA loan as an open-end line of credit loan in order to avoid coverage under the Act, and that a lender who does not verify and document repayment ability will be presumed to engage in a pattern or practice of such conduct.[7]

Based upon Chairman Bernanke's recent testimony to this Committee, it appears that the Federal Reserve Board soon will propose revisions to its HOEPA rule to address unfair or deceptive acts or practices. Consistent with my earlier remarks, I would recommend that the Board use its authority under HOEPA to apply such requirements to all lenders.

FTC Act

The Federal Trade Commission Act states, at Section 5, that "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting

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[4] 15 U.S.C. § 1639(*l*) (2).

[5] 60 Fed. Reg. 15463 (1995); 12 C.F.R. §§ 226.32 and 226.34.

[6] 66 Fed. Reg. 665617 (2001).

[7] 12 C.F.R. § 226.34.

commerce" are unlawful.[8] With respect to banks and savings associations, the FTC empowers the Federal Reserve Board, the Office of Thrift Supervision, and the National Credit Union Administration Board to issue implementing regulations to carry out the purpose of the Act, which must define "with specificity such unfair or deceptive acts or practices," and include requirements "prescribed for the purpose of preventing such acts or practices."[9] Enforcement authority is given to each of the appropriate federal banking agencies to enforce the Act and regulations. The FTC Act also directs each of the banking agencies to establish a separate division of consumer affairs to receive consumer complaints and take appropriate action.

To date, the FTC has not relied on regulations in this area. Instead, it has developed a body of principles through enforcement actions and policy statements. The Federal Reserve Board has promulgated one regulation to date under its FTC authority, the "Credit Practices Rule."[10] This rule declares that it is an unfair or deceptive practice for a bank to include a loan term in which the debtor waives certain procedural rights, agrees to an irrevocable assignment of wages, or takes a security interest in personal household goods. Additionally, the federal banking agencies have issued advisories on unfair or deceptive acts or practices based upon the FTC's policy statements, and the OCC has exercised its existing enforcement authority under Section 5 of the FTC Act on several occasions.

Ideally, any new rule based upon Section 5 of the FTC Act should be issued jointly by the federal banking agencies, in consultation with the FTC. Joint rulemaking would ensure that the rule is uniform for all federally supervised institutions. Consultation with the FTC would ensure

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[8] 15 U.S.C. § 45.

[9] 15 U.S.C. § 57a(f). In addition, the statute requires that within 60 days after an FTC rule on unfair or deceptive acts or practices takes effect, the Federal Reserve, OTS and NCUA Board shall promulgate substantially similar rules, unless the agency finds that the practice is not unfair or deceptive or would interfere with monetary policy or the payments system.

[10] 12 C.F.R. § 227.11 et. seq. This rule was based upon a credit practices rule issued by the FTC, see 16 C.F.R. 444.

that the federal rule is comparable to the standards the FTC applies to non-federally supervised lenders.

Crafting such a rule will not be easy. As former Federal Reserve Board Chairman Greenspan noted in a letter to former Congressman John LaFalce "it is difficult to craft a generalized rule sufficiently narrow to target specific acts or practices determined to be unfair or deceptive, but not to allow for easy circumvention or have the unintended consequent of stopping acceptable behavior."[11]

Consumer Complaints

After a consumer acquires a financial product or service, a consumer naturally expects that product or service to perform as advertised. When it does not, consumers should have appropriate recourse to lenders and regulators. All four banking agencies have established programs to receive and address consumer complaints, and each of these programs has been effective. The OCC reports, for example, that its Customer Assistance Center has helped consumers receive more than $30 million in relief over the past five years. Additionally, the federal banking agencies have undertaken a number of initiatives to improve coordination with state regulators.[12]

Yet, consumers do not always appreciate the legal distinctions between different types of lending institutions, and may not be sure where to turn for assistance. Therefore, it would seem appropriate for the federal banking regulators to establish a centralized system for consumer complaints and referrals under the auspices of the Federal Financial Institutions Examination Council, which now includes a representative of state banking authorities.

Enforcement

[11] Letter from Chairman Greenspan to Congressman John LaFalce dated May 30, 2002.
[12] For example, last week, the Federal Reserve Board and OTS announced a joint initiative with the FTC, the CSBS, and the American Association of Residential Mortgage Regulators to improve the supervision of subprime mortgage lenders.

Enforcement actions are an ultimate form of consumer protection. Cease and desist penalties, including restitution payments to consumers, and civil money penalties not only punish violators, but deter future violations. Consumers, however, do not care who enforces an applicable requirement, as long as someone does. Thus, policymakers should seek to balance the use of enforcement resources to ensure that consumers are adequately protected.

During the recent problems in the mortgage market, lenders of all types engaged in questionable practices. However, the institutions that have gone bankrupt because of their practices were state licensed and supervised. This suggests that state supervisory resources were inadequate or not adequately utilized.

In a natural allocation of supervisory resources, federal regulators should be responsible for federally chartered lenders, and state authorities should be responsible for state chartered or licensed lenders. Such an allocation is appropriate on both practical and policy grounds.

Collectively, the states supervise over 100,000 different financial institutions. Asking State Attorneys General to be responsible for national banks and federal thrifts, in addition to state lenders, seems an inappropriate allocation of resources. Further, as a policy matter, the system of prudential supervision exercised by the OCC and OTS can be much more efficient and effective than litigation initiated by a State Attorney General. Under federal law, national banks and federal thrifts are subject to regular examinations, and many of the nation's largest banks and thrifts have full-time, on-site examiners. This regular examination process permits federal authorities to identify potential and real violations of consumer protection statutes and regulations on a timely basis, and require corrective actions, with an impressive array of enforcement options and resources behind that requirement.

<u>Funding</u>

The final step in the consumer credit process is funding. This is not so much an issue for consumers, as it is a policy dilemma. Funding for consumer finance is provided by a combination of regulated and unregulated sources. In the mortgage market, for example, funding is provided by the GSEs, which are regulated, and private investors in mortgage-backed securities, who are not. These private investors have the ability to invest their funds in any instruments. Therefore, subjecting investors to liability for violations of consumer protection requirements will simply encourage them to make alternative investments, and reduce the funds available for mortgages. Perhaps the best way to address this is to work closely with lenders and investors to develop an approach that balances reasonable accountability with continued liquidity. Placing liability on investors for activities that are beyond their ability to know, let alone police, will not work.

Thank you again for the opportunity to appear today, and I would be pleased to respond to any questions.