The Home Equity Lending Market and Regulation under the Home Ownership and Equity Protection Act: Promises and Pitfalls

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Concerns over specific features of modern mortgages are ill-founded. None of the features of focus in today's hearing, prepayment penalties, escrows (collected or uncollected), no-doc or stated income underwriting, nor affordability requirements are per se problematic. Rather, all can be effectively dealt with by keeping in mind several key principals of regulation in rewriting HOEPA and TILA. First, financial innovation will continue to create new useful, albeit complex, financial products. Second, while there is a vast role for improved financial education, education alone will not stop fraud, nor will it effectively deal with financially innovative and complex new products that are invented year-to-year. Last, no matter the extent of regulation, some borrowers just want to borrow, no matter the disclosures or products offered. Such behavior is not sufficient justification for abrogating contracts. A final note is offered with respect to design elements that distract from the importance of the information offered in the Shumer box.

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I appreciate the opportunity to testify before Governor Kroszner and Ms. Braunstein under the Home Ownership and Equity Protection Act (HOEPA) to address the difficulties in home equity lending that have been demonstrated through the recent mortgage mess. Specifically, the organizers have asked members of the panel to opine on how laws have addressed (or have not addressed) certain practices or loan terms, specifically prepayment penalties, escrows for real estate taxes and housing-related insurance for subprime loans, stated income or low doc lending, and consideration of a borrower's ability to repay a loan.

As an academic, I have been asked to comment on how federal policy makers should approach the specific practices or loan terms described above or any others that are discussed. While my oral testimony will restrict itself to that narrow purpose, I provide these written remarks in order to advance a broader view of the market context that constrains how the specific terms and practices under consideration – prepayment penalties, escrows, no doc lending, and suitability requirements – can be disclosed and how the natural limitations of that disclosure can be addressed in a dynamic financial marketplace.

The sections that follow pose a challenge to policymakers to improve regulation without hindering new financial product development and borrower flexibility, while at same time striking a balance between pursuing fraud and misrepresentation through education and advocacy and allowing individuals and society to learn from their mistakes.

I. ACCOMMODATE NEW PRODUCTS

Nonprice loan terms like prepayment penalties and escrow accounts, per se, are not predatory or undesirable. Rather, nonprice terms tend to lower the interest rate of a loan to a level that is accessible to the borrower. While it has been standard for business borrowers to choose from a menu of nonprice loan terms associated with different stated interest rates, these choices are new to most consumers and create new challenges for consumer credit regulation. Nonetheless, the consumer credit industry has found it extremely lucrative in recent years to market on the basis of payment rather than price and consumers have become comfortable with possession rather than ownership.

Standard MBA textbooks teach that the total loan price is a function of the nonprice loan terms, the fee-based loan terms, and the stated interest rate.[1] Those textbooks teach that loan covenants are valuable promises to forgo or maintain certain activities during the life of the loan. When the borrower agrees to forgo something (i.e., dividend payments) or maintain something (i.e., a compensating balance account at the lender) for the life of the loan they are giving up the option of acting otherwise. Hence, many nonprice loan terms can be valued as a foregone option. Foregone options that reduce credit risk are valuable to the lender. Hence, nonprice terms lower interest rates by the amount of the value of the option.

While the reduced interest rate may appear attractive at the outset, however, borrowers need to remember that each of the nonprice terms may involve an additional behavioral commitment through the life of the loan or back-end

1. ANTHONY SAUNDERS & MARCIA CORNETT, FINANCIAL INSTITUTIONS MANAGEMENT 297-301 (5th ed, McGraw Hill/Irwin Publishers 2006), at 299.

payment at the end of the loan. Hence, these loans may be thought of as financial planning tools, and may constrain borrower behavior beyond merely making the payments each month. The borrower may pay dearly, however, if they decide they do not like the constraint or the financial plan later on, or forget the bargain they have struck with the lender.

A. Loans with Prepayment Penalties

A prepayment penalty is a common nonprice loan term outside the U.S. A prepayment penalty is valuable to the lender because it helps reduce prepayment risk, one of the most significant risks faced by lenders. In return for giving up the option to prepay for a certain period, the borrower receives in return a lower interest rate, and thus periodic payment, on the loan.

The financial plan that makes a loan with a prepayment penalty worthwhile is one in which the borrower does not intend to move during the prepayment penalty term. The idea is that if the borrower can benefit by credibly committing that intent to the lender and receive a lower interest rate in return. In such cases the borrower may not even pay attention to the size of the prepayment penalty, reasoning that the probability of a move is so small that the feature doesn't pertain to them.

Ex post, however, the borrower may lose their job or be transferred, or merely want to refinance their loan to take advantage of lower interest rates, during the prepayment penalty period. Ex ante, the borrower planned wrong. In such cases, it is important to remember that the prepayment penalty that some allege to be *per se* predatory has been offset by a period of lower interest payments up to the date of the move.

In many cases, the borrower could not have afforded the home in the first place without the reduced payment arising from the lower interest rate associated with the prepayment penalty. Hence, the penalty benefitted the borrower significantly in the beginning even though they did not like it in the end.

B. Option ARMs, 2/28s, and 3/27s

New products like option ARMs, 2/28s and 3/27s are similarly developed with payment as the most attractive feature. Nearly all these products are originated by brokers who instruct borrowers to refinance before the end of the teaser period. One can argue, however, that in originating such products the mortgage industry learned valuable lessons from credit card and consumer goods lending industry: many borrowers forget to switch before the teaser rate ends.

The financial plan that makes these products worthwhile is one the borrower expects to become more creditworthy by establishing a credit record and reducing the home-to-value ratio and then refinancing to another loan before the teaser rate or minimum payment period ends. The option being sold in these products, therefore, is not one of prepayment but one of extension. Since the lender expects the borrower to prepay within a couple of years, the lender can obtain funds to back the loan from shorter-term borrowing markets at lower rates on the yield curve than rates based on the typical 10-year treasury. High interest rates following the teaser period compensate the lender for the low initial teaser rate, as well as the need to fund the loan for longer than expected.

During periods of rapid home price appreciation it was easy for borrowers to switch to another loan before the teaser rate ended. Those who chose not to switch either chose to bear the higher payment or liquidate home equity to meet the higher payment demands, which is the price of failing to meet the goals of the original financial plan. In many cases, however, the borrower could not have afforded the home in the first place without the reduced payment arising from the option ARM, 2/28, or 3/27 arrangement.

C. Reverse Mortgages

Reverse mortgages are another type of financial planning tool. Of course, the payment is an attractive feature because the homeowner *receives* the payment from this transaction. The plan here is to extract cash from the home in retirement, usually with the intent of supplementing a fixed pension or retirement benefit. Similar products, called life settlements, are sold to extract the value of life insurance in the retirement years. All these products are rapidly growing in popularity as the baby boomer generation ages.

According to HUD, "A reverse mortgage is a special type of home loan that lets a homeowner convert a portion of the equity in his or her home into cash. The equity built up over years of home mortgage payments can be paid to you. But unlike a traditional home equity loan or second mortgage, no repayment is required until the borrower(s) no longer use the home as their principal residence. HUD's reverse mortgage provides these benefits, and it is federally-insured as well."[2]

While this sounds good in principal, and HUD assures individuals that, "you do not need to repay the loan as long as you or one of the borrowers continues to live in the house and keeps the taxes and insurance current, and that, "you can never owe more than your home's value," the cash that can be extracted from a home is limited and there can be substantial interest and back-end fees upon the sale of the home.[3] Hence, the plan breaks down if the payments end while there is still a need for income. Nonetheless, the individual received the benefit of living in the home while extracting its value, which can be quite valuable.

D. REX Mortgages

The last type of financial planning tool to be mentioned is the REX loan. REX loans are being marketed lately as an alternative to home equity loans in the current subprime lockup environment. In a REX loan, the borrower, "Real Estate Equity Exchange Inc. will give a consumer cash representing up to 15% of their home's value in exchange for a cut of up to 52.5% of the capital appreciation when the property is sold." The borrower, "…gets 3.5% of the gains for every 1% it pays the consumer for the option… The typical origination fee for a reverse mortgage is about $17,000, industry observers say. At the time the house is sold, there is a service charge of approximately $15,000."[4]

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[2] http://www.hud.gov/offices/hsg/sfh/hecm/rmtopten.cfm

[3] http://www.hud.gov/offices/hsg/sfh/hecm/rmtopten.cfm

[4] Southall, Brooke, "Startup Firm Allows Homeowners to Tap Equity without Payments; Real Estate Equity Exchange pays cash against appreciation, but some question idea," Investment News, February 12, 2007.

The financial plan here is to borrow for the lowest possible monthly payment – zero – while remaining in the home. The problem is that the back end fees and charges seem extremely high. While this may not seem like a good deal in the financial sense, REX loans have become popular enough that American International Group Inc. (AIG) of New York had taken a significant investment stake in the operation. In December 2006, AIG became the largest shareholder of REX, and on May 8, 2007, AIG announced that it had taken a "significant minority equity stake" in the firm.[5]

The four examples above illustrate a trend toward borrowing in arrangements that reduce monthly payments through nonprice terms or back-end fees and charges. Note, however, that these innovative products are used differently from previous straightforward consumer credit products. These products are used as financial planning tools, created to both cure credit records and acquire a place to live. Too often, however, buyers become less concerned with their credit condition after they live in the house.

Even brokers who present buyers with a financial plan and strategy, such as "even if you have to skip other bills, make every mortgage payment on time," and "be sure to refinance before the reset," find that the buyer does not adhere to the plan for regaining financial fitness. Like the patient who has a heart attack after ignoring the doctor's prescription for diet and exercise, it is up to the borrower to maintain the discipline to stick with the plan in order to avoid financial disaster.

No amount of regulation can stifle financial innovation. Each of these products is useful to the right borrower as long as the risks are understood. Hence, non-price features and back-end fees and charges that make homes more accessible should be welcomed in today's housing market to help make loans affordable to a broad population of borrowers.

II. SOME BORROWERS WILL NOT *UNDERSTAND* THE DISCLOSURES

Even though they may make loans more affordable, some features (including some of those in the complex products described above) may never be understood by borrowers. It is important to differentiate, therefore between misunderstanding arising from obfuscation and fraud, lack of education, and lack of advice and advocacy. While it is important to punish fraudulent brokers and borrowers alike, even borrowers with the capacity to understand the products with education may not be able to keep up with the myriad details of innovative financial products that can better meet their borrowing needs.

A. Fraud, Malfeasance, and Misrepresentation

Fraud, malfeasance, and misrepresentation have always existed and have grown significantly in recent years as mortgage lending has skyrocketed. Mortgage fraud extends beyond small-time crooks. Andrew Sandler, a partner at Skadden, Arps, Slate, Meagher & Flom LLP, maintains that law enforcement is

[5] Business Wire, "AIG Financial Products Corp. Announces Strategic Investment in The REX Group," May 8, 2007.

finding increasing involvement of drug cartels, and organized crime, and even terrorist funding purposes.[6]

Georgia's largest-ever mortgage fraud case was prosecuted minmid-March 2007. "The U.S. District Court for the Northern District of Georgia in Atlanta ruled March 15 that Phillip Hill Sr. was guilty of 168 counts of conspiracy, money laundering, and loan, mail, and wire fraud related to a mortgage flipping scheme. He and nine others were convicted of bilking lenders out of more than $41 million."[7]

The true level of mortgage fraud is largely unknown, but law enforcement officers, regulators, and lenders recently reported that it has spiked with the mortgage market. "A report FINCEN issued late last year said that of the 61,278 SARs filed on mortgage fraud from 1996 to June 30, 2006, 48% were filed in 2004 and 2005. The figures for 2006 dwarf all previous years, equaling more than all filings on the topic from 1996 to 2003 combined. While overall SAR filing by institutions increased only 7% last year, reports citing mortgage fraud grew 43%."[8]

Most mortgage frauds follow an established pattern. "Buyers gain control of properties at a low price and then sell them quickly at a big profit, rigging the game every step of the way by procuring bogus property appraisals and using false or stolen identities to obtain mortgages."[9] Fraudulent brokers may use unwitting buyers as straw-men and then standing prepared to strip equity from foreclosed homes on short notice.

Mortgage fraud has a dramatic impact on surrounding neighborhoods. Inflated appraisals can cause tax assessments to skyrocket and "…neighborhoods swept up in fraud rings tend to be hit repeatedly, [ultimately] leaving many houses vacant and in disrepair and causing property values to plunge."[10]

"As the housing market cools and lenders, particularly those that made loans to people with riskier, or subprime, credit scores, take a much closer look at the mortgages they underwrote, evidence of mortgage fraud is growing nationwide. The Mortgage Asset Research Institute said reports of mortgage fraud rose 30 percent for loans made in 2006 compared with those made in 2005. (The report also warned that it might take three to five years to uncover the full extent of fraud that occurred in loans made last year.) "[11]

Fraudulent real estate agents, brokers, appraisers, and other parties to the transaction will ensure that borrowers do not understand the contracts and provisions they are signing. The challenge then becomes how to provide sufficient education so that borrowers can begin to sense fraudulent actors.

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[6] Hopkins, Cheyenne, "Housing Boom Also Fertile For Launderers," American Banker, March 26, 2007.

[7] Hopkins, Cheyenne, "Housing Boom Also Fertile For Launderers," American Banker, March 26, 2007.

[8] Hopkins, Cheyenne, "Housing Boom Also Fertile For Launderers," American Banker, March 26, 2007.

[9] Creswell, Julie, "Mortgage Fraud Is Up, but Not in Their Backyards, " New York Times, Section A, p. 1.

[10] Creswell, Julie, "Mortgage Fraud Is Up, but Not in Their Backyards, " New York Times, Section A, p. 1.

[11] Creswell, Julie, "Mortgage Fraud Is Up, but Not in Their Backyards, " New York Times, Section A, p. 1.

B. Financial Education is Lacking

While regulators and others continue to promote the goal of financial education in the U.S., that goal is not being achieved. Few programs are offered in K-12 education, even fewer to immigrants, and virtually none to the elderly

1. K-12 Education

While every Federal Reserve Bank has a public outreach division that offers educational materials and curricula for K-12 education, it is up to individual school districts to avail themselves of these resources. Currently, "only nine states have personal finance instruction as a high-school graduation requirement, but last year, seven more introduced legislation to require some kind of money management instruction in public schools," according to the National Association of State Boards of Education. NASBE formed a commission last year to assess the need for such education in schools and concluded that financial literacy and investor education should be a "basic feature" of K-12 programs.[12]

Nonetheless, college students smitten with credit cards and student loans have little financial literacy of understanding of financial products to prevent them from borrowing significant amounts before they even enter the workforce. The growing problems in the student loan industry are testimony to these shortcomings.

2. Educating Immigrants

As immigrants, both legal and illegal, become more of a driving force both economically and politically, more banks are offering products tailored to their needs. In a recent report CUNA noted that some of the country's largest banks "will target Hispanics where they work and where they live, installing ATMs [for remittances] and tailoring mortgage packages that do not require traditional documentation." For example, Bank of America suggests that the bank has 10 million unbanked Hispanics living in its nationwide geographic footprint. [13]

"BoA sees a core checking account, financial education, in-language communication and remittance as the key drivers to attract Hispanic business," CUNA said in a company report. The nonprofit maintains that as the mortgage market slows, "bankers are going to focus more of their marketing attention on the nation's new Latino immigrants and the $1 trillion in disposable income this market will have by 2010."[14]

Money management training courses that teach Latinos basic financial skills "is one way financial institutions are tapping into this market," CUNA said, so

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[12] Pressler, Margaret Webb, "Kids Get Money-Smart; New Programs Are Helping Parents Prepare Children for Responsibility," Washington Post, April 15, 2007.

[13] Dymi, Amilda, "Banks Catering To Immigrants," National Mortgage News," January 15, 2007.

[14] Dymi, Amilda, "Banks Catering To Immigrants," National Mortgage News," January 15, 2007.

"completing a budgeting and home-buying course is often a prerequisite to getting a home loan for some low-income consumers."[15]

3. Educating the Elderly

One would think that the elderly, a rapidly growing population often possessing significant home equity, would be a natural candidate for financial education. However, a Lexis-Nexis search on "financial education" and "elderly" produced zero hits. I believe that this shortcoming will prove crucial as the elderly are sold complex financial products like REX loans, reverse mortgages, and life settlements in vast quantities in coming decades.

C. Delinquency Levels are Lower in States Requiring Attorneys at Closing

The presence of fraud and the limits of education, coupled with the natural development of more complex lending arrangements, lead to the natural question of how to ensure that consumers have an advocate when borrowing with complex newly-developed financial instruments.

The problem is already with us. "Freddie Mac, a government-sponsored mortgage-loan buyer, estimated that borrowers of 15 to 35 percent of all subprime loans it bought in 2005 could have qualified for prime-rate loans. Fannie Mae, another government-sponsored loan buyer, estimated up to 50 percent of the borrowers, whose subprimes it bought that year, had credit profiles that could have qualified them for prime rates."[16]

"Doug Duncan, chief economist for the Mortgage Bankers Association, said a 1999 MBA survey revealed that 31 percent of all home buyers never spoke to anyone except their real estate agent when they bought a home."[17] In my region, attorneys are common at closings in New Jersey, but not Pennsylvania. Default rates in Pennsylvania in 2Q2006 were 5.28%, compared to 3.5% in New Jersey. It appears that neither Florida nor Ohio, two hotbeds of mortgage difficulties, require attorneys at real estate closings.

While attorneys would be a needless expense at every closing, it may make sense to acknowledge the limits of contractual disclosure nonetheless. Those limits could be acknowledged through a stipulation that if the terms of a mortgage lie substantially beyond the standard disclosures represented under HOEPA and TILA, those standard disclosures recommend the borrower consult an attorney for review and assessment. Of course, the borrower would be free to proceed as they wish, but they have thereby been warned that the product they are about to buy carries some special features that they had better understand.

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[15] Dymi, Amilda, "Banks Catering To Immigrants," National Mortgage News," January 15, 2007.

[16] Christie, Les, "Wow, I Could've had a Prime Mortgage: Why many borrowers who qualified for prime-rate loans wound up with subprimes instead," CNNMoney.com, May 30 2007.

[17] Christie, Les, "Wow, I Could've had a Prime Mortgage: Why many borrowers who qualified for prime-rate loans wound up with subprimes instead," CNNMoney.com, May 30 2007.

The main point, therefore, is to prosecute fraud where it happens, provide education to help borrower decisionmaking at the margin, and provide advocacy for borrowers in complex borrowing arrangements. Such arrangements can help maintain the benefits of financial innovation while reducing potential harm to uneducated consumers.

III. SOME BORROWERS WILL NOT *CARE* ABOUT DISCLOSURES

Finally, no matter what disclosures are offered or what the terms of the loans, some people just want to buy a home and nothing about the transaction will prevent them from going forward. Some of this is just ego and greed, and if you read beyond the media hype there exists genuine responsibility on the part of many of the borrowers. Even so, however, borrowers are more inclined to ignore disclosures in rising markets and will do so again no matter what kinds of disclosure or advocacy are offered.

A. Marketing, Peer Pressure, and Praise

The Wall Street Journal recently ran an article about the "Most Praised Generation," in which it remarked that young people have been stroked and praised and told they can have it all now with no need to wait not only by marketers, but by their parents and peers as well. Just like the carnival side-show hawker, "everyone's a winner!" You play the sideshow game but soon come to realize that the prize is often insignificant.

"When it comes to praise today, "Gen Xers and Gen Yers don't just say they want it. They are also saying they require it," says Chip Toth, an executive coach based in Denver. How do young workers say they're not getting enough? "They leave," says Mr. Toth.[18] They not only leave their jobs, but they leave to find a mortgage broker that gives them a loan to buy the house they want so badly, no matter what the terms.

These young people get the insignificant prize: living in a home for a short while. But they miss out on the larger prize to be had: owning a home. No amount of disclosures or prohibited loan terms will keep them from their lesson.

B. Read Beyond the Media Hype

While the lesson above may sound pessimistic, there is hope in the media hype and it can be seen in carefully reading the articles of subprime plight. In the recent Wall Street Journal coverage, we see stories like:

> *For a long time, Paul and Amy Woodhull's house on Capitol Hill was a honey pot. Through multiple refinancings over nearly a decade, they pulled out money to fix it up, buy a car, pay down credit cards, ... The couple also pulled money out of their rowhouse to buy another rowhouse as an investment, and to buy a beach house in Delaware. Later, they refinanced the beach house to buy another one next door. They also refinanced at times to take advantage of falling interest rates, lowering their mortgage payments, which freed up more cash.*

[18] Zaslow, Jeffrey, "The Most-Praised Generation Goes to Work," Wall Street Journal, April 20, 2007; Page W1.

> *Now the pot is dry. The Woodhulls are feeling squeezed by bills, but with interest rates up and home prices down, they're reluctant to touch their home equity again. They called their six children into a family meeting recently, and Amy laid down new rules: No more impulse purchases or frivolous shopping trips. "We're going to have to save our pennies," she declared.*[19]

This is not lender abuse. This is learning how to save. These consumers probably ignored the disclosures that could have alleviated their situation, as did others attempting to mimic their situation, but there is hope that a lesson hard learned will not be forgotten. And while one may be tempted to bemoan the belt-tightening, they still have the car, the remodeled home, and the lower credit card bills and interest savings.

The media coverage reminds us that:

> *America's housing wealth skyrocketed as prices climbed earlier in this decade. According to Fed data, homeowners' equity -- the value of their homes minus mortgage debt -- grew to nearly $11 trillion at the end of last year, or double the value at the end of 1998. The housing boom also fueled spending directly by turning homes into cash machines. As prices rose and interest rates fell, Americans extracted trillions of dollars in extra cash through home sales, mortgage refinancings and home equity loans.*[20]
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> *Homeowners gained an average of nearly $1 trillion a year in extra spending money from 2001 through 2005 -- more than triple the rate in the previous decade -- according to a study by former Federal Reserve chairman Alan Greenspan and Fed economist James E. Kennedy. That's the "free cash," as the authors call it, left over after closing costs and other fees deducted from equity withdrawals. Most of the money extracted during those boom years, nearly two-thirds, came from home sales, the authors found. Another 21 percent came from home equity lines of credit, while 15 percent came from mortgage refinancing.*[21]

The media reports the heartbreaking stories, but give scant coverage to the remorse:

April Williams was feeling the pain of the downturn back in 2002, when she saw an ad from subprime lender World Wide Financial Services Inc. offering cash to solve her financial problems. At the time, production slowdowns at Ford Motor Co. were squeezing her husband's income from an assembly-line job, and they'd heard rumors that more cutbacks were coming. Still, after a loan officer from World Wide paid a visit, they became convinced they could afford stainless-steel appliances, custom tile, a new bay window, and central air-conditioning -- and a $195,500 loan to retire their old mortgage and pay for the improvements. The loan carried an interest rate of 9.75% for the first two years, then a "margin" of 9.125 percentage points over the benchmark short-term rate at which banks lend money to each other -- known as the London interbank offered rate, or Libor. The average subprime loan charges a margin of about 6.5% over six-month Libor,

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[19] Henderson, Nell, "An ATM That's Out of Money: As Housing Market Slips, Tide of Spending and Refinancing Retreats," Washington Post, May 30, 2007; D01.

[20] Henderson, Nell, "An ATM That's Out of Money: As Housing Market Slips, Tide of Spending and Refinancing Retreats," Washington Post, May 30, 2007; D01.

[21] Henderson, Nell, "An ATM That's Out of Money: As Housing Market Slips, Tide of Spending and Refinancing Retreats," Washington Post, May 30, 2007; D01.

which as of Tuesday stood at 5.38%. ***"I knew better than to be stupid like that," she says.****[emphasis added]*[22]

Similarly:

Ordell Walker, who says he left a job at DaimlerChrysler several years ago, put in a new driveway, glass-brick windows on the basement and stairwell, and much more. To get the cash, he jacked up his mortgage to $205,000 from $108,000 in 2002, partly with the help of World Wide. "A lot of people took the cash," he says. ***"I wish I'd never done it*** *myself." [emphasis added]*[23]

C. Borrowers will not Recognize Risk in a Rising Market

Even though borrowers will learn from present market conditions and the inevitable continuing fallout from the mortgage mess, some will undertake the same type of borrowing should markets experience another bout of significantly rising home price appreciation soon.

"Perhaps the biggest culprit is simply that many consumers don't know enough about mortgages to question the deals they're offered. … many consumers enter some of the biggest financial deals of their lives with their eyes wide shut… If you've got plenty of money and don't mind not getting the best rate, listen to your realtor."[24] When home price appreciation is in the double-digits and income is rising, borrowers again will not take the time to properly understand the risks they are assuming.

The main point I am making here is that over-borrowing, in isolation, is not a reason to abrogate contracts. None of the tear-jerking media stories of late are justifications for abrogating contracts or devoting government money to bailouts.

IV. SUMMARY AND CONCLUSIONS

Throughout I have made the points that financial innovation is valuable and should not be stifled by product restrictions, education and advocacy can work together to educate consumers on a case-by-case basis to better meet the needs of borrowers going forward, and that while the current situation is a mortgage mess of over-borrowing the lessons to ensure the mess will not recur soon are communicated best by allowing existing contracts to remain in place.

One more point I would like to make is extremely mechanical but extremely important. People disregard the current disclosures partially because of education and knowledge, but also partially by design. Edward Tufte provides a superb

[22] Whitehouse, Mark, "Day of Reckoning: 'Subprime' Aftermath: Losing the Family Home: Mortgages Bolstered Detroit's Middle Class -- Until Money Ran Out," Wall Street Journal, May 30, 2007; Page A1.

[23] Whitehouse, Mark, "Day of Reckoning: 'Subprime' Aftermath: Losing the Family Home: Mortgages Bolstered Detroit's Middle Class -- Until Money Ran Out," Wall Street Journal, May 30, 2007; Page A1.

[24] Christie, Les, "Wow, I Could've had a Prime Mortgage: Why many borrowers who qualified for prime-rate loans wound up with subprimes instead," CNNMoney.com, May 30 2007.

discussion of design elements formulated specifically to obfuscate and confuse rather than simplify and clarify. One classic application is the cancer warning on a package of cigarettes. "In a sinister piece of disinformation

from a billboard advertising cigarettes, a thick frame clutters the words of warning (by activating the negative white space between word and box) just as a waving hand masks small moves of the fingers in [a magician] switching coins. The sans serif, capital letters minimize distinctions among letters and words, contributing to the difficulty reading. 'Where scrutiny is damaging, scrutiny is diverted,' explains *Magic by Misdirection*."

In fact, the existing Shumer box is similar. The inefficiency is immediately apparent from Tufte's perspective. One's attention is drawn away from the important information, leaving the mind boggled rather than enlightened. Here is an example from a large credit card issuer:

Pricing & Terms

Please take a moment to carefully review the Pricing & Terms below.

RATE, FEE AND OTHER COST INFORMATION

Annual Percentage Rate (APR) for purchases
Elite and Premium Pricing:[a] A 0% fixed APR for the first 12 billing cycles following the opening of your account. After that, 14.24% variable[b] for Elite Pricing, or 18.24% variable for Premium Pricing. Standard Pricing: From account opening, 23.24% variable.
Other APRs
Balance Transfer APR: Elite and Premium Pricing: A 0% fixed APR for the first 12 billing cycles following the opening of your account. After that, 14.24% variable for Elite Pricing, or 18.24% variable for Premium Pricing. Standard Pricing: A 0% fixed APR for the first 3 billing cycles following the opening of your account. After that, 23.24% variable. Cash Advance APR: Elite and Premium Pricing: 24.24% variable. Standard Pricing: 28.24% variable. Default APR: Up to 32.24% variable. See explanation below.[c] Overdraft Advance APR: 13.99% fixed (not available in some states)
Variable rate information
The following APRs may vary monthly based on the Prime Rate:[d] Purchase APR: Elite and Premium Pricing: The Prime Rate plus 5.99% for Elite Pricing, or plus 9.99% for Premium Pricing for outstanding and new balances after the introductory period. Standard Pricing: The Prime Rate plus 14.99%. Balance Transfer APR: Elite and Premium Pricing: The Prime Rate plus 5.99% for Elite Pricing, or plus 9.99% for Premium Pricing for outstanding and new balances after the introductory period. Standard Pricing: The Prime Rate plus 14.99% for outstanding and new balances after the introductory period. Cash Advance APR: Elite and Premium Pricing: The Prime Rate plus 15.99%. Standard Pricing: The Prime Rate plus 19.99%. Default APR: The Prime Rate plus up to 23.99%.
Grace period for repayment of purchase balances
At least 20 days
Method of computing the balance for purchases
Average daily balance method (including new purchases).
Annual fee
None
Minimum finance charge
$1.00
Transaction fee for balance transfers
3% of the amount of each transaction, but not less than $5.00 nor more than $75.00.
Transaction fees for cash advances
3% of the amount of the transaction, but not less than $10.00.
Late Payment fee
$15.00 if the balance is up to but not including $250.00; $39.00 if the balance is $250.00 and over.
Over-the-Credit-Limit fee
$35.00
International Transactions
3% of the U.S. dollar amount of the transaction, whether originally made in U.S. dollars or converted from a foreign currency.

Proposed replacements from the banks alter minor design elements, but do not alleviate the problem because lenders do not have a genuine interest in full disclosure.[25]

Financial products are not going to get simpler, and no amount of prohibited or regulated features will constrain financial innovation. Hence, a balance of disclosure, advocacy, and harsh realization of the limits to regulation will provide the most useful revisions of consumer protection legislation now and in the future.

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[25] Furletti, Mark, "Federal Consumer Protection Regulation: Disclosures and Beyond. Summary of Conference Held at Federal Reserve Bank of Philadelphia," Federal Reserve Bank of Philadelphia Payment Cards Center, June 10, 2005.