S. HRG. 112–385

CONSUMER PROTECTION AND MIDDLE-CLASS WEALTH BUILDING IN AN AGE OF GROWING HOUSEHOLD DEBT

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING CONSUMER PROTECTION AND MIDDLE-CLASS WEALTH BUILDING

OCTOBER 4, 2011

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

74–143 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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C O N T E N T S

TUESDAY, OCTOBER 4, 2011

CONSUMER PROTECTION AND MIDDLE-CLASS WEALTH BUILDING IN AN AGE OF GROWING HOUSEHOLD DEBT

TUESDAY, OCTOBER 4, 2011

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 3:10 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. The Committee will come to order. Thank you all for joining us. I apologize. I thank Senator Corker for actually being on time, and I apologize for being late. We were trying to work through some details on the currency bill on the Senate floor. Senator Corker spoke against it; then I spoke for it; and then the two leaders were working out some details, as they are wont to do. And I needed to stay to start to manage the bill, but thank you, all of you, for joining us. I thank Senator Merkley and Senator Hagan also for joining us.

With our economy still recovering from the financial crisis, it is critical to understand how excessive household debt remains a burden to our Nation's full recovery, understanding that we can better put our Nation back on the road to prosperity. Credit can be undeniably a good thing. It allows people to borrow against their future earnings to purchase essential goods and services. It allows families to buy homes and students to go to college. It helps people pay for food and clothing.

It also can cause irreparable harm when those future earnings never materialize due to job loss or stagnant wages. It can undermine our economy when it is offered on terms designed to take advantage of consumers rather than to help their wealth grow. It is that capacity for wealth to grow that makes America a stable and prosperous country. It is that capacity to generate wealth and pass it down to future generations that really has created and preserved our middle class.

But over the last three decades, in the last decade in several years in particular, the pathway to a strong economy and a strong middle class has been more and more difficult to travel. From 2000 to 2010, median income for working-age households fell by more than 10 percent. In that same decade, poverty increased overall by almost 4 percent. These are merely averages. The statistics, as we know, are far worse for Hispanic and African American households than they on the average in white households.

Behind the statistics are stories of Americans forced to try to borrow as a substitute for stagnant wages and declining household value assets, and some were preyed upon by a burgeoning predatory lending industry. Cities like Cleveland and Dayton, here Doug is from, are clear examples of this devastating combination. In Cleveland, the same year that the LTV steel plant was filing for bankruptcy, Cuyahoga County officials were begging the Federal Reserve to crack down on predatory mortgage lending practices.

Likewise, in Dayton, as Mr. Fecher knows all too well, we lost GM's Moraine plant, a large assembly plant, at the same time that groups like the Miami Valley Fair Housing Coalition were going door to door educating the West Dayton community about the dangers of predatory refinancing schemes. The growing reliance on debt led to a vicious cycle. Our declining manufacturing base contributed to the dangerous growth of the financial sector.

Financial services industry output went from 15 percent of U.S. gross domestic product in 1980 to 21 percent of GDP in 2010. Over that same period, manufacturing declined from about 21 percent of GDP to not much over 11 percent of GDP. Encouraged by predatory lending practices and flawed Government policies, including financial deregulation and free trade agreements, household debt reached 133 percent of household income by 2007, the highest level since the beginning of the Great Depression. The ensuing financial crisis exposed failures throughout the financial sector. It continues to affect families across Ohio and the Nation who have been hurt by the tremendous destruction of jobs and wealth and assets. Just this week we learned that household incomes dropped during the month of August.

But we had good news that the manufacturing sector expanded. Wages actually declined in manufacturing and services and goods-producing industries, and Americans were forced to tap their savings to cover those losses.

The need to address these issues could not be clearer. I hope we can find some areas of agreement today because I know that Senator Corker shares some of my concerns about our indebtedness.

I remember in our hearing in February Senator Corker wondered whether new rules for debit card fees would push consumers from checking accounts that are backed by a consumer's assets into credit cards that are debt instruments. We did not ultimately agree on the swipe fee issue, but I understand and appreciate his concerns from that.

Professor Porter notes in her testimony that while Wall Street is too big to fail, American families are too small to save. And from reading the first chapter of your book, it is almost that American families were also too small to be noticed by policy makers.

It is important to remember that excessive household debt is dangerous to individual families but also is a problem for all of us.

Professor Mian estimates that the deleveraging process caused 4 million of the 6.2 million jobs lost between March of 2007 and March of 2009. I wear a canary pin on my lapel signifying many things, one of them the canary in the mine the mine workers took down to the mines, where the mine worker had no protection of a union that was strong enough or a Government that cared enough in those days, and the mine worker was on his own. The canary—in many ways household debt in this country is the coal mine of our economic security.

If you think that indebtedness will not cause greater problems for society, I would tell you to look at what is happening in cities across the country now—thousands of people in the streets protesting, among other things, illegal foreclosures, excessive student loan debts. Their activism reminds us that we ignore these issues at our own peril and the peril of the futures of our children and grandchildren.

I look forward to exploring ways that policy makers can encourage responsible borrowing and sensible consumer protections. I am confident that the new Consumer Financial Protection Bureau will be a tool to help American families rebuild some of the wealth that they have lost over the last decade. I look forward to a vote in this Committee, I believe perhaps as early as Thursday, on whether to confirm former Ohio Attorney General Richard Cordray as the first Director. I think that would be good for American families and good for the American economy.

Senator Corker.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you. I will be very brief. I think one of you actually has a flight to catch, and I do not usually make long comments anyway.

I will say that I am looking forward to your testimony. I probably more than anybody on our side of the aisle spent a great deal of time trying to negotiate a consumer protection bureau and really think that we should have one. It is my hope that the Administration will try to institutionalize and not cause it to be something that is personality-based where one person that is a know-all is setting the landscape for the entire financial industry, but instead of that there will be some appropriate checks and balances. And I think if that occurs ever, we will actually end up having someone leading the consumer protection agency with the appropriate type of institutional checks and balances.

I will also say that while I very much agree with my friend regarding some of the concerns that I have with consumers, sometimes we as policy makers create policies that have unintended consequences. And, you know, it is pretty interesting to see the senior Senator from Illinois on the floor sort of apologizing to everybody in some ways that in creating the Durbin amendment we basically shifted money out of the pockets of consumers into the bottom line of Walmart and Target and other entities. So unintended consequences do occur.

Whether you agree or disagree with what I just said, the fact is we need to be careful as policy makers, and I look forward to your help in making sure that we make prudent decisions. So thank you for being here.

Chairman BROWN. Thank you, Senator Corker.

Senator Merkley, do you have an opening statement? Senator Hagan, an opening statement? OK. Thank you.

I will introduce the panel with brief introductions, then go from left to right. And, Ms. Porter, thank you for being here, and if you have to leave, certainly we will be mostly concluded, perhaps entirely concluded by then.

Atif Mian is an associate professor of economics and finance at the Haas School of Business at the University of California at Berkeley. His recent work is centered on understanding the origins of the global financial crisis, the political economy of Government intervention in financial markets, and the link between asset prices, household borrowing, and consumption.

Katherine Porter is a professor of law at U.C.-Irvine where she teaches courses on consumer bankruptcy and consumer law. She is a regular contributor to Credit Slips, a blog that discusses issues related to credit and finance and bankruptcy. She is the editor of the forthcoming book, "Broke: How Debt Bankrupts the Middle Class."

Robert Lawless is a professor of law at the University of Illinois College of Law, codirector of the program on law, behavior, and social science. He is a regular contributor to the blog Credit Slips. From January to May of 2000, he was a visiting professor at the Ohio State University's College of Law. I am sure that he still regrets leaving to this very day.

Ray Boshara, also an Ohio native, is senior advisor at the Federal Reserve Bank of St. Louis. His work at the Fed focuses on household financial stability with an emphasis on strengthening the balance sheets of American families, how that contributes to economic growth. He served as an advisor the Clinton, George W. Bush, and Obama administrations. He is a graduate of Ohio State. No more comment on that.

Michael Flores is president and CEO of Bretton Woods, Inc., a specialty management consulting firm serving financial institutions, with 30 years of financial institution experience through his employment in banking as well as consulting. Welcome.

Douglas Fecher is president and CEO of Ohio's largest credit union, Wright-Patterson Credit Union, a credit union with $1.5 billion in assets. He worked his way up from a teller to become the CEO, a position he has held for almost 11 years. He is past director and chairman of the Ohio Credit Union League.

IDA Rademacher is the vice president for policy and research at the Corporation for Enterprise Development. She leads its policy and research team in their efforts to advance comprehensive research and policy agendas that expand asset- and wealth-building opportunities for all Americans.

Last, Susan Weinstock is the project director for the Pew Charitable Trusts' Safe Checking in the Electronic Age Project. Previously she was the financial reform campaign director at the Consumer Federation of America. Prior to joining them in 2009, she worked on a number of different positions at AARP.

Professor Mian, if you would begin. Thank you all for joining us.

STATEMENT OF ATIF MIAN, ASSOCIATE PROFESSOR OF ECONOMICS AND FINANCE, HAAS SCHOOL OF BUSINESS AND DEPARTMENT OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. MIAN. Thank you, Chairman Brown and Senator Corker, for inviting me. I am going to talk about the role of household leverage in the current economic crisis and the importance of household balance sheets in explaining macroeconomic fluctuations. My comments today are based on research that my coauthor Amir Sufi and I have done over the years.

In order to understand the role of household balance sheets in the current economic slump, we must begin from the unprecedented and staggering increase in household debt during the 2000s. The sharp expansion in the supply of mortgage credit in the U.S. resulted in U.S. household debt doubling from $7 trillion in 2001 to $14 trillion in 2007. This massive accumulation of debt by households with largely stagnant real wages was not sustainable. Correspondingly, toward the second half of 2006, mortgage delinquencies started to creep up, and about five quarters later the U.S. enters into a full-blown recession.

Our research shows quite conclusively that the main reason for the U.S. economic collapse was a process referred to as "deleveraging" of household balance sheets. That is, faced with reduced net worth, highly leveraged households sharply cut back on consumption to conserve debt capacity and pay back existing debt.

For example, we find that consumption such as the sale of new automobiles drops significantly more in areas with highly leveraged households. This drop in consumption severely impacted job losses as well. For example, job losses in the nontradable sectors, such as retail where businesses must depend on local demand to survive, job losses in such sectors were much higher in highly indebted counties. Extending these job losses over the entire economy, we find that we can conservatively attribute 4 million of the 6.2 million jobs lost between March of 2007 and March of 2009 to this process of deleveraging. In other words, 65 percent of total jobs lost in the U.S. are due to this deleveraging, and the drop in aggregate demand as a result of it.

Policy choices in the face of extremely damaging effects of deleveraging and aggregate demand cycle are somewhat obvious. We must do more to facilitate principal debt reduction for highly indebted and underwater homeowners. The economy can neither afford to foreclose these homes nor bear the costs associated with reduced aggregate demand. Despite almost 4 years since the start of the deleveraging cycle, only $1 trillion out of the $7 trillion of debt accumulated over 2001 to 2007 has either been paid down or written off.

The dilemma for efforts to reduce household indebtedness is that from a lender's perspective it is not in their interest to write down debt that continues to be serviced on time. But as my analysis highlights, the collective consequences of such individually rational actions are quite unpleasant. If a large number of financially distressed homeowners cut back on consumption in order to protect their homes and continue paying their mortgages, the aggregate demand and employment consequences hurt everyone. Therefore, I repeat, we must do more to facilitate principal debt reduction for highly indebted and underwater homeowners.

In the long run, it is important to keep in mind that the relationship between high household leverage and long economic slumps is not limited to our current experience. In his seminal paper, Irving Fisher in 1933 described the role that high household indebtedness played in deepening and perpetuating the Great Depression. In order to prevent such episodes from happening again, we need to reevaluate our financial structure. In particular, I would submit that we need to put in place contingencies that will automatically write down the value of outstanding debt if the overall economic environment is sufficiently negative.

For example, mortgage principal can be automatically written down if the local house price index falls below a certain threshold. If we had such contingencies in place in the current mortgage contracts, we could have avoided the extreme economic pain due to the negative deleveraging and aggregate demand cycle.

I thank you very much for your time and consideration.

Chairman BROWN. Thank you, Dr. Mian.

Dr. Porter, Ms. Porter, thank you.

STATEMENT OF KATHERINE PORTER, PROFESSOR OF LAW, UNIVERSITY OF CALIFORNIA IRVINE SCHOOL OF LAW

Ms. PORTER. I appreciate the opportunity to talk to you today about the reasons that thoughtful consumer protection is a vital necessity to our country's future economic health. The decade of increases in consumer debt has reshaped the prospects of American families, and the recovery from the recession presents challenges for families trying to make prudent financial decisions and navigate this difficult economy. These challenges mean that consumer credit law will be a major determinant of the well-being of families for decades to come.

Before the recession, for decades families added debt. In the mid-1980s, the ratio of debt to personal income, personal disposable income was 65 percent. By 2007, that U.S. household leverage ratio had more than doubled, reaching an all-time high of 133 percent. Unfortunately for families, the debt binge was not accompanied by meaningful increases in disposable income. While income crept up, debt jumped up.

The growth in debt also outstripped the appreciation of assets, eroding the wealth of families. As far back as 1995, the amount of mortgage debt began to increase faster than house values, and between 2001 and 2004, a period of relative prosperity, the typical household's wealth actually declined. This expansion in borrowing spanned social classes, racial groups, sexes, and generations. Every age group except those 75 years or older took on increased debt between 1998 and 2007. African Americans, Hispanics, and non-Hispanic whites all become more indebted in this same period.

People who lack a high school diploma and families headed by households over age 65, between 65 and 74, had particularly sharp increases in debt. By 2007, when those debt burdens peaked, 77 percent of households had some type of outstanding consumer debt. Consumer debt has become one of the most common shared qualities of the middle class, higher than the fraction of the population that owns a home, is married, has graduated from college, or attends church regularly. And as that debt increased, so, too, did the risk of financial failure.

Today millions of Americans are struggling to avoid financial collapse. We all hope that the worst of the financial crisis is over. Subprime lenders have gone bankrupt. Most subprime and non-traditional mortgage products were eliminated by the market and later, for good measure, by the Federal Reserve and the Dodd-Frank Act. In the aggregate, families are dialing down their debt loads, and lenders have changed their practices.

Some may use this credit retrenchment to argue against consumer protection laws or to justify reconfiguring the Consumer Financial Protection Bureau. In my opinion, these efforts are misguided. They fundamentally misunderstand the nature of the consumer debt overhang that is harming families and the overall economy. It is precisely in today's turbulent, difficult economy that an energetic and dedicated consumer protection regulator is needed to aid families. Why?

First, a regulator is needed because consumer debt remains at a level that would have been unthinkable a generation or two ago. Overindebtedness was not a temporary feature of the U.S. economy, and it is not a problem of the distant past cured by the recession, Government stimulus programs, or Dodd-Frank.

Second, consumer protection is crucial because default rates remain very high. Foreclosures are a well-known story, but other worrisome trends exist, including significant increases in student loan default rates and a 28-percent increase last year in complaints to the FTC about debt collectors. Debt collection and default are not isolated experiences. They are now a routine and painful part of what it means to be middle class in the United States.

Third, credit retrenchment, which has begun, will be a long and painful process. For many families it will mean lost homes, repossessed cars, second jobs, and dunning from debt collectors. Changes in credit standards and fears about taking on credit make it harder for families to hang onto the rung on the economic ladder where they are or to climb up it.

Fourth, a Consumer Financial Protection Bureau can help ease anxiety about the turbulent economy. Americans' appetite for risk reflects in part the insecurity that they face because of their debt loads. Americans are frustrated with the lack of an effective and sustained Government response to their hardships. Asked in 2010 whom Government had helped a great deal during the recession, 53 percent said banks, 44 percent fingered large corporations, and just 2 percent thought economic policies had helped the middle class. The banks may have been too big to fail, but families seem to have been too small to save. Middle-class Americans feel abandoned and that the Government's response to the financial crisis missed their pain.

Today families are in uncharted territory, facing risks in the job market, declines in Government service, and uncertain access to credit. It is precisely in this environment that consumer protection law can help families regain confidence in the American economy and make informed and smart decisions to rebuild their wealth. In this economy, the Consumer Financial Protection Bureau, which is charged with monitoring the functioning of the credit markets, can be of use to develop outreach and education initiatives and provide technical expertise to lawmakers.

I urge the Committee to move forward with the Consumer Financial Protection Bureau, confirming a Director so that its important work can begin.

Chairman BROWN. Thank you, Professor Porter.

Professor Lawless, welcome.

STATEMENT OF ROBERT M. LAWLESS, PROFESSOR OF LAW, UNIVERSITY OF ILLINOIS COLLEGE OF LAW

Mr. LAWLESS. Thank you, and thank you for inviting. In your invitation letter, you asked me to address household debt and the trends in household debt and how those trends affect in the extreme bankruptcy filings. But before I get into that, I want to talk a little bit about the subtext of what is, I think, in everybody's mind as we're talking here—this new financial regulator that is about to come on board.

One of the things that I think people have forgotten is that in the lead-up to Dodd-Frank, in the wake of the financial crisis, there was a lot of discussion about what should happen. Then there are people like me. I am a believer that there are some products out there that people just cannot possibly afford. And I think the best solution to fixing those products is to ban them altogether.

Now, I understand that is a controversial position. Not everyone is going to agree with that. But people of good faith and good judgment can differ over those type of policy outcomes.

I think one of the things that has been forgotten in today's debates and with the heated rhetoric is that one of the reasons the Consumer Financial Protection Bureau was so popular at the time of Dodd-Frank was that it was in many ways a compromise solution between those who would go further and those who felt that not a lot needed to be done.

I would hope that, as we begin to discuss what the shape of the Consumer Financial Protection Bureau will look like going forward, we will remember that it was, again, in many ways a compromise solution.

What you asked me here today mainly to talk about was about trends in household debt, and, Senator Brown, in your opening statement, you have already discussed some of this. I will not belabor the point. But one thing I would like to highlight that is in my written testimony is comparing the United States to other countries.

You talked about the tremendous run-up in household debt over the past generations, and it is absolutely correct. In preparing for this testimony, I ran some numbers. Consumer debt in this country, even after you adjust for population growth and inflation, has increased 46 percent in the past 25 years, 106 percent in the past 50 years. That is not counting mortgages. If you put mortgages into that calculation, private household debt is 220 percent more than it was 25 years ago, and 374 percent more than it was 50 years ago—almost 4 times as much.

We live in a very different time than our parents and our grandparents. Today, people coming of age can expect to be indebted for most of their adult lives.

The United States, according to statistics from the Organization for Economic Cooperation and Development, leads the world in short-term debt. We owe $9,663 per capita in short-term debt, things like credit cards and payday loans. These are the types of loans that are most likely to be taken out on short notice, most likely to be taken out under pressure, most likely to be taken out without full information, and most likely to be subject to abuse.

Moreover, household debt is undoubtedly linked to bankruptcy. Indeed, I think it is a common fiction that what drives bankruptcy filings in this country are the ups and downs of the economy. That turns out not to be true. It is outstanding household debt. Debt creates conditions for bankruptcy in the long run. In the short run, decreasing availability of credit puts people who might otherwise be able to stave off the day of reckoning into bankruptcy. You can actually have increased bankruptcy filing rates in economic boom times, like the 1990s, when high consumer borrowing in the early part of the decade laid the conditions for people to need bankruptcy and then some lesser availability of consumer credit drove them into the bankruptcy courthouse.

You can also have decreased bankruptcy filing rates in economic busts, as is going to happen this year when bankruptcy filing rates will be down about 10 percent. Why? In the immediate aftermath of the 2007–08 financial crisis, people were less able to borrow, creating less need for bankruptcy today. And according to the Federal Reserve, consumer credit is now slightly easier to get than it was at this time last year. People are able to use borrowing to stave off the day of reckoning.

So it is not the economy, which, again, I think people mistakenly blame for bankruptcy rates. They think that layoffs or unemployment is what is driving bankruptcy. Statistically, it turns out to be the amount of household debt.

Now, the Consumer Financial Protection Bureau, of course, was not created to stop debt. As Senator Brown noted, responsible borrowing is good. People borrow to finance their houses, to finance automobiles, to finance their education. But what the Consumer Financial Protection Bureau is there to do is to stop the abuses that place individual households at risk of things like bankruptcy and to act as a check on runaway lending practices that place our whole economy at risk, as Professor Mian indicated.

Thank you again for inviting me.

Chairman BROWN. Thank you very much, Mr. Lawless.

Mr. Boshara, proceed. Thank you.

STATEMENT OF RAY BOSHARA, SENIOR ADVISOR, FEDERAL RESERVE BANK OF ST. LOUIS

Mr. BOSHARA. Well, I am not only a proud graduate of OSU, but Revere High School in Akron, Ohio, and I worked for Congressman Tony Hall for many years, so plenty of Ohio credentials here.

I need to say that, of course, these are my own views and not necessarily the views of the Federal Reserve Bank of St. Louis or the Board of Governors of the Federal Reserve System.

I was asked to talk about solutions more on the other side of the balance sheet: How do you help families build up savings and assets? Let me get right to my punch line.

Looking back, we have seen the damage to families, communities, and the broader economy derived from three severe balance sheet shortcomings:

First, we as a Nation let debt levels rise to damaging levels.

Second, we did not help families buildup their savings.

And, third, we failed to help families diversify their assets beyond housing.

Going forward, we must address, proactively, each of these shortcomings. We need adequate savings, good wealth-building debt, and a diversity of assets. In other words, we need to look at the entire balance sheet, especially of low- and moderate-income families.

When we build up net worth, we will see two things:

First, we are going to see a stronger economy. Several people have identified weak balance sheets at the core of the economic downturn. The IMF, the Bank for International Settlements, others on this panel. If we strengthen balance sheets, we can turn that around and help revive the economy.

Second, when we buildup net worth, we are going to see stronger families and better economic mobility outcomes. What researchers have done over the last several years is isolate what is called the "asset effect." What do you get from asset ownership, independent of income, education, and a whole other series of factors? What do you get when you own assets that you do not otherwise get? You get more mobility. You get better health outcomes, and better child outcomes, better educational outcomes. So building assets gets you better financial security, and a better society as well.

I have five ideas in my written testimony, but first let me say something that unifies my recommendations. Building assets is not a new idea. The Federal Government is already very generously in the asset-building business. Through tax breaks for retirement, home ownership, college savings, investment, and business ownership, we have very generously encouraged better-off families, the upper half of the population, to build savings and wealth. I, therefore, think that the core policy challenge is to take this great policy that we have for building wealth for better-off Americans and make it work for those in the bottom half. How do we extend the savings mechanisms and incentives so that they work for people below median income? We need to "bundle" savings and investment opportunities for the lower half just as we have for the upper half. So it is not a new idea here; we just have to extend what we are doing already.

So what are my five ideas? First, build assets early in life. As I mentioned, when one has assets, the better he or she will do. It turns out that the earlier in life you have assets, the better you are going to do. The best idea that I know of is to establish savings accounts at birth for every child born in America with greater resources directed at lower-wealth families. And I am pleased to recognize the leadership of two Members of the Subcommittee for their work on this issue: Senator Schumer and Senator DeMint. If we cannot achieve such an ambitious policy, I would encourage us to think about something like a "Kid's Roth" or a "Young Savers Account" or a "Roth at Birth"—a voluntary account that would let kids start saving for some kind of a long-term asset.

Second, we need to build assets at tax time. The IRS now has a "split refunds" form, which lets you take your refund and send it to three separate accounts. We can do a lot with that infrastructure. We also can improve the Federal Saver's Credit, which Senator Menendez has provided leadership on.

Third, we can build assets at the workplace. I benefit, many of the folks in this room benefit, from the Federal Thrift Savings Plan. That and other kinds of retirement plans have built enormous pension wealth in this country. We can use that infrastructure to build other kinds of wealth as well for low-income families.

Fourth, build unrestricted savings. You know, this is a "sweet spot." Families with unrestricted savings get better wealth-building financial services, better debt, and the ability to purchase long-term assets.

And fifth, think about the 529 college savings platform as an opportunity to build savings and wealth. In Oklahoma, they are testing the idea of giving every child a 529 savings account at birth. And in the city of San Francisco, they are testing the idea of giving every kindergartner a college savings account. We can learn from these innovations.

Finally, let me close by saying that we do not necessarily have to spend new money to move forward on this agenda to build assets for the bottom half of the population, for two reasons:

First, we can imagine a more efficient allocation of current asset-building subsidies. We should strive to subsidize economic activity that would not otherwise occur, which is the case for the bottom half of the population.

And, second, we can tweak existing products, forms, and systems. As a matter of fact, "auto 401(k)s," "split refunds," my proposed "Kid's Roth,"—none of these have or would cost the Federal Government any money but could generate literally millions and billions of dollars of new savings and assets by the poor.

Thank you.

Chairman BROWN. Thank you, Mr. Boshara.

Mr. Flores.

STATEMENT OF G. MICHAEL FLORES, CHIEF EXECUTIVE OFFICER, BRETTON WOODS, INC.

Mr. FLORES. Good afternoon. Thank you, Mr. Chairman, Senator Corker, Senator Merkley. I appreciate the opportunity to be here today.

I take a little bit different approach to this. As you noted in my bio, I have been in the financial services industry for 30 years. Actually, I have been consulting for 30 years. I started in banking about 7 years before that. I have seen a lot of changes in the industry, and what I want to focus on today is the impacts, as Senator Corker had mentioned, on unintended consequences of regulations, some that we are seeing right now, and then relate that to the CFPB and some concerns that I have there, not that I do not agree that we need a CFPB, it is how it is structured, how it is implemented.

First of all, let me talk about the banking business model and why we are having less access to the middle class, the people we are talking about are starting to be marginalized out of traditional mainstream banking. The banking model is a 20th century banking model. The commercial banking system has not figured out the 21st century model yet, and it is for good reason.

They have two sets of customers. They have their legacy customers, and I hate to say baby boomers, but the older customers that still want the branch, still deal with checks, still use cash, and still go to the teller line. Then you have the Gen Y customers that will probably never step into a branch and do everything off their PDA. This is their bank.

The bank has to support both those cost structures right now, so there is extreme pressure on their earnings. Banks have had margin compression for the last 15 years. What do they do to address that? They try to get more to a fee model. How do they do that?

Well, overdrafts were the first shot at that, and I am a guilty party. I helped install some of those overdraft programs. But we did it for checks because that was a service to the consumer. If you returned the check, you are going to pay two to three times more than if you paid that check in the overdraft originally. Where we went off the rails with this thing is opening it up to debit card transactions. There was no value in that $3 plus $35 cup of coffee that everybody talks about.

Then we ended up with interchange fees, and interchange was not driven initially as a source of fee income. It was driven to push people to a new service delivery model. Use that debit card. Stop writing checks. Get rid of the paper out of the system. Reduce reliance on cash. Use that debit card. People started using the debit card. The income started rising, so this is a great deal. Then we have regulation that addressed that and has reduced both overdraft income as well as interchange income.

Expenses—we have increased interest expense in banks by fee regulating, Reg Q, and allowing payment of interest on business accounts.

And finally, and all my clients talk about this, are compliance costs. Banks under $1 billion, one, do not know if they have the money to afford good compliance officers, and two, where are they going to find good compliance officers? They are few and far between and it is an extreme cost that is being added.

So the bank is being squeezed from revenue, on the expense side, and what needs to be done, then, to address this? Why are banks not offering the services to the middle class? Service charge income—you have read in the last two or 3 days the new service charges going in, and as you had said, we have now had a transfer of wealth from the consumer through the bank to the merchant, which was not the intended consequence of the original legislation.

Alternatives to checking accounts—with these high rates, people are going to start dropping checking accounts. What is the alternative? Right now, it is the general purpose reloadable prepaid card. Well, there are some restrictions in that that say if you allow the consumer as a service to pay their bills with that card, then we are going to not allow the exemption for the prepaid cards on interchange.

And so the providers are faced with, do we cut service or do we cut our revenues, and that is yet to be determined what is going to happen.

Finally, let me talk about the CFPB for a moment. As I said earlier, I think it is needed. My concern is there is a concentration of power the way it is currently structured, and I am concerned about accountability. I think my opinion is it should be accountable to Congress.

And finally, I believe the Director ought to report to a board, and let me tell you why. I think that board ought to be representative of prudential regulators and members of the industry. That way, when regulations are proposed, all those people can deal with—the prudential regulators can deal with safety and soundness issues, because right now we separate safety and soundness from consumer protection. And members of the industry can make their point of what is the potential unintended consequences of the proposed regulation.

So what are the options that are available out there right now? Well, overdrafts are still there for checks, and I still maintain that is a valuable service to the consumer. The other option for credit are what some of the larger banks are testing, deposit advance products, which our next member of the panel will talk about his product. Yes, they are expensive, but they are in demand. And it is interesting when you talk about demand. With Reg E, you are requiring the consumer to opt in for debit card transactions, which I thought would be very low because I did not see the value. It has turned out to be an extraordinarily high opt in. Why? I do not understand. It is the consumer acting, saying they want that service. So I think we need to strike a balance, consumer needs, consumer-driven, market-driven solutions versus strictly regulatory-driven solutions.

I will be happy to answer any questions. Thank you.

Chairman BROWN. Thank you, Mr. Flores.

Mr. Fecher, welcome.

STATEMENT OF DOUGLAS FECHER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, WRIGHT–PATTERSON FEDERAL CREDIT UNION, FAIRBORN, OHIO

Mr. FECHER. Thank you. Thank you, Mr. Chairman. We have spent a lot of time talking about consumer balance sheets, and I am with Wright-Patterson Credit Union and we are in the business of fixing consumer balance sheets. We are in Dayton, Ohio, as you noted. We are a community hard hit by this economy. In the last 3 years, we have lost 33,000 jobs in Dayton. Our members are facing an uncertain financial future.

I have a lot of the same statistics some of the other witnesses had on the incredible rise in consumer debt over the years, the drop in their savings rates, which at one point even became negative, the drop in their home prices, and the one that is most alarming to me, household net worth is $5.5 trillion less today than it was at the beginning of the financial crisis.

But I am the one on the street trying to serve these folks who come in that are overloaded with debt. They cannot afford to make their next car payment. They are worried about their house. They do not know what to do next and they come to see me at the credit union and our staff.

Clearly, the need for our affordable financial services have never been greater, and that is where I think the cooperative credit union model comes into play. Our mission is simply this. We help folks achieve financial freedom for themselves and their families.

Specific to debt, this whole issue of debt, the way you make good loans is you make them up front in a way that they can afford to be repaid and you know that going in. You make them for provident and productive purposes, not speculative purposes. You tell the members exactly what their loans are going to cost. You make sure they know every single fee that they might be faced with in the future. You take every opportunity to advise the member on how to increase their savings accounts, even when they are taking out a loan. And if they do happen to fall behind, you treat them with dignity and respect and work with them on a plan to bring them back to financial health, if that includes modification, adjusting their rate, or whatever it takes to get them back to financial health, although I do not agree that reducing principal balances ultimately will just shift the cost somewhere else in the economy.

These principles are the foundation of the way Wright-Patterson Credit Union lends money. We try to create an environment where we help people change their lives. In my written testimony, you will see several stories of how we serve members through mortgage modifications, credit cards that are not designed to tempt people to spend money but designed to help them pay down their debt. We have emergency payday loan products that are affordable for a borrower who runs into a short-term need of emergency cash.

We educate. We serve the airmen and airwomen of Wright-Patterson Air Force Base and we find them in great need of first-time car buyer loans, but they have never borrowed money before and they do not know how. So we teach them how to do that through our financial counseling and education services, just to name a few of the things that we have done.

We are proud of the way we help our members save because we can see the impact it makes on their lives, but I have to take the other side on some parts of this. Like all smaller financial institutions—we are under about $2 billion in assets—we face challenges that make it harder for us to do this stuff. Since 2008, we have been given more than 160 new rules and regulations from some 27 different financial agencies, or Federal agencies, despite the fact that our Nation's credit unions had nothing to do with the financial crisis.

While we would rather hire loan advisors, the people that can meet with our members to teach them how to make better use of their own money, we find ourselves trying to hire compliance officers, and that is the truth. It is not a statement other than the truth. And all we really do with those compliance officers is demonstrate that we have always tried to do the right thing. The fact is, our Nation's community-based financial institutions, as I sit here today, are worried that, ultimately, if you are under a billion dollars in assets, you could be regulated out of business. This country does not need fewer small institutions, it needs more of them.

I would also like to comment briefly on the CFPB. I have to admit, we are a little concerned that it might create another level of regulation for us to follow, but we support the goals of the agency. There are abuses going on that need to be curtailed. I note that we have a branch in an area of town next to a pawn shop, next to a payday lender, and the only one there that is regulated is us. The CFPB needs to address that fact.

I also think that the greater transparency in the simplified disclosures that a new agency such as this would require would highlight the way credit unions have always done business. I can also talk about Richard Cordray. He has outstanding qualifications and he understands the unique role of credit unions and what they do in the lives of consumers. But I have to say this. We hope the agency empowers credit unions and other lenders to do their jobs of helping consumers to save and make better use of their loans without adding an excessive regulatory cost. And we hope Congress will ensure the Bureau fulfills its mandate to address unnecessary and burdensome regulation.

I will close quickly with an email I received just last week from a member who personifies the typical financial challenge faced by our membership. I quote, "I am writing you today to inform you of the difference your company has made in my life. My previous car payment was $348, and with my rent being $699 a month, including my other household bills, I could barely make ends meet. Some weeks, I could not feed myself due to the strain of having this enormous car payment. Just 2 weeks ago, your credit union approved me for a car payment of $192. You guys saved me $156 each month. My interest rate went from 24 percent to 8 percent. You guys helped me keep food on the table."

I get emails like this all the time and it affirms to me that we are doing exactly what you want us to do. We are taking care of consumers, helping them improve their financial situation, putting money back in their pockets. In fact, this year alone at Wright-Patterson Credit Union, we have saved our members more than $10 million in loan interest costs by refinancing their high-interest loans to lower rates.

To conclude, I believe in the power of America's cooperative credit unions. We have always been here for consumers, often when they have had nowhere else to go, in good times and bad. A credit union cannot be bought and it cannot be sold. If Congress strengthens and empowers credit unions, credit unions will do even more to help people keep more of their hard-earned money.

I will be happy to take any questions that you have. Thank you.

Chairman BROWN. Thank you, Mr. Fecher.

Ms. Rademacher.

STATEMENT OF IDA RADEMACHER, VICE PRESIDENT FOR POLICY AND RESEARCH, CORPORATION FOR ENTERPRISE DEVELOPMENT

Ms. RADEMACHER. Thank you. Good afternoon, Chairman Brown and Ranking Member Corker and also Senator Merkley. I commend you for devoting a hearing to the issue of building middle-class wealth at a time when our collective and individual balance sheets are very much in the red, as we have been hearing about.

Some would argue that in the current economic climate, it is not realistic to focus on saving and wealth building, but saving is exactly the right issue to focus on. It is critical for low, moderate, and middle-income households precisely because these are the families most vulnerable to income shocks from job loss, medical emergencies, and other costs which can knock them totally off course financially. And borrowing one's way out of one emergency often sets up a downward spiral of debt that can be extremely difficult to recover from.

The need for short-term credit can also be understood as a need for liquidity and for savings. Research from the Urban Institute shows that a relatively small nest egg of about $4,000 provides as much protection against material hardship in the face of an economic shock as being in the next highest third of the income distribution.

The middle-class squeeze in America is more pronounced and more consequential than at any time in modern history. Regarding savings, over half the population does not have that $4,000 nest egg I just mentioned. And regarding wealth, the latest report from the Pew Hispanic Center found that the median household wealth for Hispanics fell 66 percent from 2005 to 2009, 53 percent for African Americans, and 16 percent for white households. The net worth of white families now stands at 18 to 20 times that of Hispanic and black households in America, the largest gap in 25 years.

Regarding credit and debt, I will not go over all of the statistics my colleagues here have already talked about. I would say that over half of consumers in the U.S. have what can be considered subprime credit scores at the moment.

The recession has clearly exacerbated financial problems, but at another level, these problems reflect years of Government policy decisions that disproportionately, if unintentionally, help high-income households build assets while virtually ignoring the needs of middle-class and explicitly penalizing efforts by low-income households to save and to invest.

Last year, CFED and the Annie E. Casey Foundation published a report called "Upside Down" which showed the Federal Government spends upwards of $400 billion a year to encourage Americans to save and to build assets. But the policies are primarily embedded in the tax code, and as a result, they are overwhelmingly inaccessible to middle- and lower-income households who do not itemize and who have a limited tax liability.

In the study, we found that taxpayers making $1 million or more in 2009 received a tax break of about $95,000, which is enough to help finance a pretty good college education for one of their kids. Tax filers making less than $20,000 got a break worth about $5, which is enough to pay for 2 days of school lunch. This expensive, ineffective, and skewed allocation of tax subsidies has been relatively ineffective at generating new net savings and has added to both the Federal deficit and the growing wealth gap.

Without adequate savings, without adequate income, or without adequate product options, the real financial choices of millions of Americans are limited. I would urge Members of the Subcommittee to take the following actions to improve the financial security of all Americans.

First, confirm a Director to lead the CFPB. One of the main goals of Dodd-Frank was to unify the entire financial services marketplace under one set of clear, transparent rules with consumer financial well-being in mind. Without a Director, the CFPB is limited in its ability to regulate in many sectors of the market, including nonbank financial institutions, payday lenders, private education lenders, consumer credit rating agencies, and mortgage servicers.

Congress should also encourage the CFPB to focus on improving disclosures for all consumer financial products and on helping consumers build their credit scores by ensuring the accuracy of credit reports and by expanding the amount of information reported to consumer credit rating agencies that could help build the credit files of thin and no-file consumers.

Beyond the CFPB, Congress can do much more to support the goals of wealth building in low and moderate-income families. Specifically, Congress should remove penalties in our safety net programs for developing savings that can help families move beyond—move into financial independence. Congress should follow the lead of States like Ohio that have eliminated asset tests in their TANF program. Congress could also consider reforming the asset test in the SSI program, following the trend of asset limit reform occurring at the State level for TANF, SNAP, and Medicaid programs.

By expanding the savers' credit and making the credit refundable, Congress could provide a powerful, easy, safe incentive to as many as 50 million lower-income tax filers who desperately need to build savings. Congress additionally enacting the automatic IRA would enable the 78 million workers who lack access to employer-sponsored retirement plans to use payroll reductions to open and fund IRAs with minimum effort.

Congress should reauthorize the Assets for Independence Act, which supports one of the few programs geared specifically to low-income families that helps to support wealth building and financial education to help these households get ahead.

And Congress could also support, as my colleague raised, the creation of child savings accounts to greatly expand the economic mobility of millions of children.

Taken together, these policies cost a small fraction of the billions of dollars the Federal Government currently spends to subsidize asset building, and they could easily be funded by capping some of the existing and exclusive tax breaks now in place. More importantly, they would begin to address some of the long-term inequities that contribute to the wealth gap, and they would help millions of families build a more secure economic future. Thank you.

Chairman BROWN. Thank you, Ms. Rademacher.

Ms. Weinstock, welcome.

STATEMENT OF SUSAN K. WEINSTOCK, DIRECTOR, SAFE CHECKING PROJECT, PEW HEALTH GROUP, THE PEW CHARITABLE TRUSTS

Ms. WEINSTOCK. Thank you. Thank you for the opportunity to discuss Pew's research on the importance of transparent and fair financial products and services as well as their use as a means to build and sustain wealth. Based on research and critical analysis, the Pew Health Group seeks to improve the health and well-being of all Americans, an important component of which is consumer financial product safety.

The most common of these products is the checking account, which 9 out of 10 Americans have. In October 2010, the Pew Health Group's Safe Checking Project began a study of more than 250 types of checking accounts offered online by the 10 largest banks in the U.S. which held nearly 60 percent of deposits nationwide. Through this research, we identified a number of practices that put consumers at financial risk, potentially exposing them to high costs for little benefit.

I would like to highlight three of our policy recommendations. Number one is the need for a disclosure box laying out account terms, conditions, and fees. Number two is complete disclosure of overdraft options. And number three is prohibition of transaction reordering that maximizes overdraft fees.

First, 111 pages. That is the median length of disclosure documents from the 10 largest banks in the United States. I think we all can agree that disclosures are critical for consumers to make informed decisions, but the information needs to be presented in a format that is clear and understandable. Obviously, with 111 pages, the checking accounts in our study did not meet this transparency standard. These documents are not user friendly, with highly technical and legalistic text. For this reason, we developed a model disclosure box to provide relevant information to checking account customers which is included in my written statement.

In developing a disclosure box, we tested drafts with consumers in three cities. Participants thought the box would be useful if they wanted to investigate a bank's offerings and/or compare multiple banks on the basis of fees. As a follow-up, in July of 2011, we commissioned a national survey of U.S. checking account holders. Seventy-eight percent of account holders believe it would be a positive change to require banks to provide a one-page summary of information about checking accounts' terms, conditions, and fees, while only 4 percent think this would be negative.

Our second research finding concerned overdraft options. Currently, there are two main categories of overdraft products. We define overdraft penalty plans as short-term advances made for a fee by the bank to cover an overdraft, the median cost of which is $35. Overdraft transfer plans involve a transfer from another account, either a savings account, a credit card, or a line of credit, with a median cost of $10.

As of August 15, 2010, new Federal Reserve rules required that customers must opt into an overdraft penalty plan that covers debit card transactions at points of sale and ATMs. If a customer does not opt in, any debit card transactions that overdraw the account will be denied and no fee will be charged. While Pew supports this rule, we would have preferred for the Fed to also require that comprehensive information about all available overdraft options, including fee amount, be provided to consumers who need to understand that they have three overdraft options and what each costs: Not opting in, which is free; overdraft transfer plans; and overdraft penalty plans.

Now that these rules have transferred to the Consumer Financial Protection Bureau, we believe that the CFPB should amend the overdraft rules to ensure that overdraft policy disclosures are clear and comprehensive. They should require full disclosure of all three overdraft options prior to opt in and as part of the disclosure box.

Americans strongly support this added disclosure. In our July survey, 83 percent of account holders said they want banks to be required to provide a summary of information about overdraft options, while only 2 percent said this would be a negative change.

An additional research finding is on bank processing of deposits and withdrawals. Banks' reorderings of transactions can greatly impact the overdraft fees that consumers incur. At the time of our study, all banks and all accounts reserved the right to process all debits presented in a given day from highest to lowest dollar amount. Since that time, Wells Fargo, Chase, and Citibank disclosed that they will no longer reorder certain types of transactions for at least a portion of their accounts.

Posting orders that maximize overdraft fees, especially those that post withdrawals from largest to smallest, continue to be the subject of court challenges. A Federal judge in California ruled against a bank on this practice and stated in his summary of the case, quote, "The essence of this case is that Wells Fargo has devised a bookkeeping device to turn what would ordinarily be one overdraft into as many as 10 overdrafts, thereby dramatically multiplying the number of fees the bank can extract from a single mistake."

Depository institutions should be required to post deposits and withdrawals in a fully disclosed, objective, and neutral manner that does not maximize overdraft fees, such as chronological order. Our July survey shows that 70 percent of checking account holders agree.

Finally, this month, we will release a longitudinal study of 2,000 low-income Los Angeles area households. We found, not surprisingly, that between 2009 and 2010, a time of great economic turmoil, the ranks of those without a bank account increased, with more families leaving banking than opening accounts. But what was surprising was the most common reason these households cited for leaving banking was unexpected or unexplained fees, not the loss of a job or a decrease in salary. We also found in times of economic decline, consumers with a bank account fared better and were more likely to be able to pay bills and also save for the future.

Our research demonstrates the central role that bank policies and practices have in allowing consumers to understand the terms and conditions of their bank accounts. Making this marketplace fairer would allow consumers to manage their money responsibly. Providing information in a clear, concise disclosure box will enhance competition and make the market more efficient.

In addition, practices that maximize fees, like transaction reordering, should be prohibited. Transactions should be processed in a predictable, objective, and neutral manner that responsible consumers can follow. These changes will allow consumers to build and sustain wealth by removing much of the hidden risk currently found in checking accounts. Thank you.

Chairman BROWN. Thank you, Ms. Weinstock. Thank you all.

Mr. Boshara noted in his testimony that family wealth has been concentrated in home ownership, which he said, quote, "has contributed to the stability and upward mobility of millions of families in this country." Well, we know the effects of the housing crisis, including both predatory mortgages and foreclosure fraud, on middle-class wealth building. Let me ask a specific question that all eight of you, I would like to answer. Be as brief and as concise and prescriptive as you can.

What can consumer protection do to promote home ownership as a vehicle for saving? And you, unfortunately, Professor Mian, had the least time to think about the answer, but I will start with you. What can consumer protection do to promote home ownership as a vehicle for saving in the sort of traditional ways that we used to or have in this country, and many people still are able to?

Mr. MIAN. I think that the main problem, at least in hindsight and from our historical experience, has been that even when these kind of policies are successful, sometimes they may be too successful in the sort run, like we saw in the 2000s when the home ownership rate increased by a lot, and that, in turn, can lead to a boom or a bubble in house prices, as well.

So as we think about incentivizing people to build value in their houses, we should also think about what if the economy as a whole makes a mistake and things turn south. Do we have the protection, the downside protection, that is, and that is something I was emphasizing in my initial remarks, as well. We also need to think about downward protection. And that is why I was talking about we should—when we put these regulations in place, we should also think about circumstances. How will the regulated and the economy react in case house prices fall by 20 percent and we have to reallocate the savings and debt across the economy?

That is the fundamental problem that we are facing right now, and I would just urge lawmakers to think about those scenarios, as well, and not just expanding or helping homeowners with more access, but in circumstances when things turn south, how will the economy react, or will we force people to go into foreclosure and things like that.

Chairman BROWN. Professor Porter.

Ms. PORTER. I think one answer is that buying a house is one of the biggest financial decisions people will make and it is an opportunity for them to have conversations with thoughtful, concerned financial institutions like the community financial institution that Mr. Fecher works for, about their overall financial profile.

So one of the things we have already seen the Consumer Financial Protection do is respond to its mandate in Dodd-Frank to simplify disclosures and create a combined Truth in Lending and RESPA disclosure. So go from multiple disclosures enforced by multiple regulators to one disclosure enforced by one regulator. That kind of simplification and the kinds of financial education that the Consumer Financial Protection Bureau is doing, that conversation about purchasing a home needs to be seen as part of a larger financial strategy, not as a one-off decision that is a sure bet in the economy, because as Professor Mian says, it may not be.

So I think part of it is to continue to emphasize counseling, purchasing, disclosures, and to think about home ownership as one step toward building a financial future rather than as the only step or as a sure bet financial strategy for middle-class families. We have too many families who put all of their savings eggs in the housing basket, and I think the financial education role of the Bureau and the initiatives they have already rolled out in this regard, their "Know Before You Owe" initiative is a good example of how to combat some of that.

Chairman BROWN. Thank you.

Professor Lawless.

Mr. LAWLESS. Yes. I will try to be really brief, because I think there is consensus here, and I think this is a consensus in the academy that there has been too much of an overreliance on home ownership as a way to build wealth rather than focusing on housing as an item of consumption.

So, Senator, with all due respect, I would somewhat argue the question. I do not think that we ought to use home ownership as a wealth-building strategy, although I do agree home ownership is something that many people will aspire to and something that we ought to encourage. But I would encourage us to think about housing costs rather than home ownership, and as Professor Porter and Professor Mian said, have home ownership just be part of a much bigger financial picture.

Chairman BROWN. Thank you.

Mr. Boshara.

Mr. BOSHARA. Well, I agree very much, of course, with the recommendation to diversify a family's assets beyond their homes, as I have mentioned. I think that is the most important thing.

Second, we need to be clear that home ownership is something that is not for everybody. We have to balance risks and rewards and be smart about how we do home ownership going forward.

Specifically, though, to generate savings, there are a couple of ideas. One is that we could escrow savings, just like we escrow mortgages, mortgage insurance and property taxes, so that when you make your payment, a portion of your payment goes automatically into a savings account and you just buildup this savings account without thinking about it, and so that when the roof breaks or you have some sort of emergency, you have a stock of savings already generated. So, you know, I would think about building in that savings product into the payment itself.

The other thing I would think about is thinking of ways to let families capture the upside of wealth accumulation through their homes, which is what we want, and then, therefore, using that equity for other asset building purposes, but to pool the risk of a down market. You know, is there a way to somehow socialize the risk of price decreases. Professor—I wrote down his name and do not have it here—you know, there are proposals out there right now to basically pool the risk of a down market so more homeowners can reap the upside of a good housing market.

Chairman BROWN. Thank you, Mr. Boshara.

Mr. Flores.

Mr. FLORES. I think we are getting there. I think banks are getting back to the traditional underwriting requiring 20 percent down. That is going to say a lot of people are not going to qualify for home at this point in time. If they save and get to that 20 percent down, then they will.

The next issue, and I take a little bit different tack than my colleague over here is home equity lines of credit. Over the last 10 years, it has been a piggy-bank for consumption and that is eaten—even if we did not have a down economy, that has eaten up their equity. That economy just exacerbate it.

So I think if somebody has that, if they have got the equity, if they are going to go in for a home equity line, then certainly counseling about what is the impact, what are the appropriate purposes of home equity should suffice, and this all boils down to financial literacy. Whatever form that takes, whoever provides it, it is a need in this country.

Most people do not understand how to handle money. They do not understand the basics of banking. And then when we get into these high dollar credits that they are involved in, they need some assistance in understanding that.

Chairman BROWN. Mr. Fecher.

Mr. FECHER. Thank you, Senator. I would agree with some of the previous commenters, that we need to be careful to think that just owning a home is a way to build wealth. In some cases it is; in very many cases it is not. If I were advising a member, I would make sure that they have a savings account set up and get in the habit of putting money into it before they ever thought about building wealth through a home, because when the downside hits the housing market, it hits hard, as we have seen, and it can wipe out every bit of wealth that a moderate income person might have.

So I think as part of the bigger financial picture, just as has been discussed on the disclosure side of it, I agree. We need a shorter way to tell members what, or consumers, what a mortgage loan is going to cost them and their family, what the consequences of future events might be, for example, if it is a variable rate loan, not what the first payment is going to be, but what the highest payment of the loan might be so that they do not spend money they do not have to spend on a loan that they can put back toward their health.

So it is a complex answer, but it is part of a bigger financial picture and it takes sitting down with the member and showing them what is best for them, and each situation is different.

Chairman BROWN. Thank you, Mr. Fecher. Ms. Rademacher.

Ms. RADEMACHER. Thanks. I think it is important to think about saving as both something that has to do with the product and the protections, and when you think about a house, in terms of the product and what it takes to get the right product, consumer education, specifically home purchase education and the home prepurchase counseling is critical.

Also, the types of disclosures that are available so that somebody can understand the kind of product they are purchasing. It is a very important piece of the mix. In terms of protections, I think that the CFPB is already looking into this in pretty expensive ways.

I would say that one of the studies we did a couple of years ago when we looked at home owners who had purchased homes, low-income homeowners who had purchased with an IDA, compared to other low-income homeowners in those same communities that had purchased homes at the same time, that IDA gave them prepurchase counseling and ensured that they had savings and skin in the game when they went into that.

When we looked at long-term rates of home ownership and long-term foreclosure rates, we found that if you compared the low-income homeowners from the IDA study with other low-income homeowners in that area, less than 1 percent of the IDA purchasers used a subprime loan *versus* 20 percent in the larger market, and the foreclosure rate was about three times less.

So I would say that home ownership is still a value for us to think about in terms of a way for low-income communities to build wealth. It has to be done very clearly, concisely, with the kinds of inputs and the kinds of education and the kinds of protection others have talked about. Thanks.

Chairman BROWN. Thank you. Ms. Weinstock.

Ms. WEINSTOCK. I should first say that Pew is a data-driven organization and we really have not looked at housing per se, but I also want to say that I think it is very important that people be banked, and that the research that we did in Los Angeles proved that.

Forty-seven percent of the banked said that they saved when they could, and one-third of all banked used an automatic savings feature to move money regularly into a savings account. And also, I think the savings part is the first step to moving on to greater purchases or whatever.

Chairman BROWN. Thank you. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and again, thank each of you for your testimony. As I look at the panel, sort of Mr. Boshara over, I think most of the witnesses have talked about solutions and ways of moving ahead. I look at the first three witnesses as more talking about consumers as victims. And it has really been interesting to sort of have that dichotomy here on the panel.

It seems to me that western democracies in general, governments have over-levered, consumers have over-levered. I mean, it has been sort of the culture, if you will, of western democracies in many ways, not every one of them, but certainly in our country, and Senator Brown and I were talking and I certainly could not blame Democrats for all of this occurring.

There have been some policies that they have pursued. I certainly could not say that Republicans were to blame. It just seems to me that as a society, what we have done over the last 20 years or so is really move toward people consuming a lot more and taking on more credit, and much of what we are seeing happen today is just a result of our culture.

I wonder if the first three witnesses, in any way, would respond to that briefly.

Mr. MIAN. Thank you, Senator. Yes, I think that is a question that I analyze almost on a daily basis. I apologize if my speech kind of sounds more like an academic or an economist, but that is just the nature of how things are.

Any economy has two kinds of people, borrowers and those who lend them money, the lenders and the savings, and that is true for the U.S. and that is true everywhere. That is number one, that is basic fact number one.

Basic fact number two is economies overall are going to make mistakes. Things are going to go up and sometimes things are going to come down, house prices, other kinds of assets and so on. The problem that we are having in the U.S. and, indeed, the problem that we having globally is the following: We had a big bubble, let us assume that happened, in the housing market, for example.

As things come down, we have to distribute losses across the population. That is just a fact of how the things are. And the question is, how are those losses distributed across the population? Under the way our financial system is structured, which is largely a debt-based financial system, debt is the losses.

The first person to get hit with those losses is the borrower. That is just the nature of those contracts, and that is fine. I think at the individual level that is fine. We can say each person is responsible for how much they borrow. But none of us individually control the macroenvironment.

So when the macro environment turns negative, the losses are disproportionately shifted on one segment of the economy. So internationally that happens to be Greece. Within the U.S. that happens to be underwater homeowners and the borrowers.

And the big question is, what do they do in response to that financial pressure that is being shoved in one segment of the economy? This is what I talked about in my opening remarks. They are cutting back. Many of them are still paying back their mortgages and so on, but they are cutting back drastically on their consumption, which is affecting aggregate economy and total output and employment.

The big question is, that problem can be solved if people who are the lenders and the savers correspondingly increase their consumption. But interest rates have fallen to zero and they are still trying to save. That is why interest rates are zero, because they still want to save more and more.

So there is this dichotomy that on the one side, the savers and those without the wealth, they actually are still trying to save a lot more when they should be reallocating their money back into society in goods and services. But they are not being convinced to boost their consumption and their investment.

And that is the misbalance that we have had, because of this over-leveraging of the economy in the household sector for the U.S., and also more globally with the sovereign debt problem. And we have to realign this tension, this dichotomy between the saving class and the borrowing class, and part of it has to be that we have to distribute losses more equitably. That is a challenge for the financial system as a whole.

Senator CORKER. I find your solution really odd. I mean, you have got 9 out of 10 borrowers who are current on their mortgages. You have got 1 out of 10 that are not, and what you have really thrown out is the bank creating a partnership with the borrower so that when things are all good, the borrower bears the fruits of— or has the fruits of home equity, but when things go bad, then the principal amount goes down as far as what the bank is owed. That is really strange.

And what that does, I think, is drive up everybody else's borrowing cost within the system. So I have to say, that is one of the oddest proposals I have ever heard and really goes against the grain of those people who are responsible being able to get lower rates to borrow their loans because they are responsible. Those people that are irresponsible, in essence, are creating a burden for every other borrower. And you think that is the way we should solve this problem?

Mr. MIAN. I think partly one can argue that it is true that the cost of credit was too cheap or too low. So to the extent that we put part of the perceived burden looking forward back on the lenders so they price these costs in, it might actually be useful to limit the over-leveraging of the sector.

So just the fact that the cost of credit goes up, it is not always good for the cost of credit to go down if people do not take into account these macroeconomic costs, or extranalities as they are sometimes referred to. That is number one.

But I think that the broader principle is that one can design these contracts in a way that you can also give some of the upside to the lender so as to minimize the cost up front. And certainly, if someone comes in with enough of a downpayment, it will actually build into the downpayment requirement as well.

If someone comes in with enough of a downpayment, then you do not have to worry about the bank absorbing too much of the down side.

Senator CORKER. Obviously during the Dodd-Frank debate, I tried to cause there to be a minimum downpayment. I think what you are actually arguing is what many folks on my side of the aisle have argued for years, and that is that people ought to have a reasonable downpayment.

I think Mr. Flores alluded to that and I think Mr. Fecher agrees with that. People ought to have a downpayment and we should not subsidize the interest rates for housing. They ought to be based on fair market values, and that is something that many of us have been arguing for years. Hopefully we will get to that point.

But I have to say, the idea of basically creating a partnership whereby if things go good, one side wins. If things go bad, the lender loses. It is really odd and I doubt that will make it into the mainstay here. But do you want to go ahead, Mrs. Porter, and respond?

Ms. PORTER. So you hypothesize that—you said that you think it has been sort of the culture of democracies to over-lever?

Senator CORKER. The culture recently in many western democracies has been over-consumption, by Government, by individuals, by—you know, it has just been an over-spending type of arrangement. And I find many of these solutions, solutions that are being created to sort of cause people's culture to overcome the culture that has been created, when maybe the real solution is just causing people to not consume as much and not borrow as much.

I mean, what really happened was, it seems to me that financial institutions were meeting the needs of consumers. Consumers wanted to be able to borrow more and they did. There is no doubt there are products that were out there that were tricky, and I understand all that, and I am all for disclosure.

I myself, I feel like I am fairly sophisticated, but have a difficult time reading some of these disclosure forms. I am all for that, but the fact is, it seems like many of the solutions or many of the things that you all talked about was people being victims when, in essence, it is kind of way society has been in general over the last 20 or so years.

Ms. PORTER. OK. So I do not think of consumers as victims and I do not think I used that word. What I do think is that there have been decades of taking on increased debt. Part of that increased debt reflects stagnation in wages and difficulties in keeping up with levels of consumption.

So we have had very sharp increased costs in health care, sharp rises in tuition costs, a run-up in the housing market which in part was fed by cheap credit in the housing market. So some of the costs of treading water have been met by borrowing.

I think that one of the major justifications for getting the Bureau put to work quickly is I think we have gone from, as you said, cultures of over-levering to just sort of cultures of panic. And so we see families who really do not know what to do in today's economy. Should I still buy a home? Is buying a home still safe? If it is, what kinds of products are out there? How should I navigate in this economy?

And I think that having the Bureau fully operational with a confirmed director, it lets the financial institutions know where to take their questions and concerns. It lets families know where to take their questions and concerns. So I think it is finding that new culture going forward. We need certainty in order to do that.

And so, I think that part of this cultural change is we know consumers are dialing down on consumer debt and that consumer debt is dropping. What they do not always know, as some of the other panelists have talked about, is where to put that money if they are not going to consume it, how to save it properly.

And so, I think the CFPB, the Bureau, is a very important part of rethinking our culture and engaging in conversations with financial institutions about their role and engaging in conversations with families and bringing those two parties together for conversation. I think right now you just have uncertainty about the future of the Bureau.

Senator CORKER. This Bureau is going to have an even more expanded role than I thought in causing culture to change. Let me ask you this. I mean, would it be detrimental, do you think, to this new Bureau to have a board of directors that this new person who is doing all these things you just mentioned could bounce off decisions? I mean, would that be something that you think might be helpful to someone who might be heading this Bureau?

Ms. PORTER. I think there already are procedures in place in the design of the Bureau that Congress enacted.

Senator CORKER. But would a board be harmful?

Ms. PORTER. I think a board could be harmful, yes. I think that the procedures that are there, like the normal Administrative Procedures Act rulemaking provide a well-known, long-standing mechanism.

Senator CORKER. What kind of organization do you have? What is the name of your organization?

Ms. PORTER. Oh, sorry. Who I work for?

Senator CORKER. Yes.

Ms. PORTER. I am a law professor.

Senator CORKER. OK. And does the school that you work with, do they have a board of directors?

Ms. PORTER. We have regents, but we also have a president that wields an enormous amount of power.

Senator CORKER. And does he have a board of trustees?

Ms. PORTER. We have regents. That is what they are called.

Senator CORKER. So board of regents.

Ms. PORTER. They do not have control over everything and they are different than Federal regulators. Most Federal agencies, the Department of Transportation, the Department of Agriculture, they have single secretaries that are headed by single institutions, single people, and we have chosen that structure for the vast majority of Government organizations for a reason.

Our financial regulators, like the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the FDIC are headed by single people. So I think the Bureau has important checks built into it and I support those checks.

The fact that they have to go through the rulemaking process and allow for rules to have public comment, the fact that the Financial Stability Oversight Council has a role in looking at what the Bureau is doing, and if necessary, in their belief, to serve this financial system, vetoing those rules.

So I strongly support the checks that are there. I think Congress thought very hard about them just 1 year ago. But I would not restructure the entire Bureau. And I think this threat of restructuring is delaying the Bureau from beginning its really important work. I think families need that work to start. They are tired of waiting.

Senator CORKER. Well, look, I do not think I have been as constructive today, Senator Brown. I apologize. I want to say to all of you who have testified, from Mr. Boshara over, that I really appreciate the comments you have made. I know our staff has made notes and I think there have been a lot of constructive comments made.

I do think as it relates to the Bureau, that it is unlikely, based on just reading the tea leaves, that there will be a Bureau head unless there are appropriate checks and balances, and it is my hope, very soon, I know that I have reached out to the Administration, I know others have.

I hope that very soon those types of checks and balances, just having a board and an appropriate veto process, will actually occur. I do not think that that is an end-all by any stretch solution to many of the problems that have been laid out.

I do want to thank the panelists on this side for many of the solutions that you have laid out and the input that you have given today, and certainly, Mr. Fecher, the proactive activities that are taking place within your organization, and certainly the savings issues that you brought forth, Mr. Boshara.

Chairman BROWN. Thank you. Now, Ms. Porter, I know that you need to leave at 4:30. It is 4:30. We are not asking you to leave because you disagreed with Senator Corker because you actually agreed with me or I agreed with you. But thank you.

I have one question, two more questions, and then if Senator Corker wants to go again he certainly can too. Any of you can answer, any or all of you. Ms. Rademacher said something, she pointed out in her written testimony, consumers accumulated $18-plus billion in new credit card debt in the second quarter of 2011, a 66 percent increase over the same quarter in 2010.

What do any of you make of that? Anybody want to answer that? Do not feel obligated, but if any of you want, I would like to hear any thoughts.

Mr. FLORES. I think you are operating from a much lower base. From 2007 to 2008, credit card lines were cut significantly. Balances were reduced significantly. So when you look at the growth, that percentage is from a smaller base than we have dealt with historically.

Chairman BROWN. Anybody else? Ms. Rademacher.

Ms. RADEMACHER. I would agree. I think, especially if you look 2 years past, the growth from 2 years ago was 368 percent. So I do think there is a rebound. People in the last couple of years have gotten comfortable with the credit available again and are becoming—moving more toward the use of credit in the ways that we had seen it before. So I agree that it was a shock that had dipped credit use and then it is actually building again.

Chairman BROWN. OK. Professor Lawless.

Mr. LAWLESS. Yes, I just wanted to add that this illustrates the falsity of the idea that somehow we are now in a changed society, that we had this big run-up in consumer credit and now, with the financial crisis, subprime lending is gone, we are going to be in a different society going forward. I think that is just a falsehood and I think the recent statistics probably indicate that.

Chairman BROWN. OK. Thank you. One more question. In an August Subcommittee hearing, I asked the minority's witness about the lack of a permanent director at the Consumer Bureau. He said, quote, The anomaly of not confirming Mr. Cordray is there will be imposition of the banking sector of consumer rules, not a bad thing, but there will not be an imposition of those rules in the nonbank financial sector, the shadow banking system not a good thing.

Mr. Fecher, your discussion of the credit union that you recently opened to members Center and West Dayton and the Wright-Dunbar area of Dayton, what does the lack of a full-time director mean for your credit union in relation to who your competitors are in that neighborhood?

Mr. FECHER. Well, I think it is exactly as you just said. The fact of the matter, I am the most regulated financial service provider in that neighborhood. The least regulated are the payday lenders and the pawn shops that are right next door to me.

It is difficult on the consumers. It is difficult on us. We support the CFPB and what it tries to do, but the first place I would put them is at the unregulated financial service provider, the shadow banks and so forth that you talked about because that is where the real abuses are taking place. They are not taking place in the typical banking sector for the most part, in my opinion.

Chairman BROWN. You talked in your testimony, Mr. Fecher, about the increasing number of regulations. Can the Consumer Bureau help you streamline those regulations and small institutions generally?

Mr. FECHER. I certainly hope so. I certainly hope so. The burden—when I first got into this business back in '80s, to make a first mortgage loan took a handful of pieces of paper to disclose the loan to the borrower. Today the package can be 100 pages or even 200 pages long.

When I think of 200 pages that we have to print, train our employees how to understand, how to explain them, I just see dollar signs adding up. And here is the twist to it. It has gotten so complex, I think as Ms. Weinstock said, people do not read them. They do not understand them. They do not even try because it is a daunting task to look at this stack of pieces of paper.

So what I would like to see the CFPB do is just make it easier on the consumer to understand the cost of what they are doing in a page or two, if possible, and we need to get rid of these entire stacks of disclosures that just confuse everybody.

Chairman BROWN. Thanks. Mr. Flores, last comment.

Mr. FLORES. I would just like to make one comment on the shadow banking system. I have done research in the alternative financial services space, and yes, payday loans are not legislated or regulated at a Federal level, but they certainly are at a State level, and in some States, rather significantly just like State-chartered banks are.

So I think it is a bit misleading saying they are unregulated.

Chairman BROWN. OK, thank you. I found Senator Corker's comments interesting and we have discussed briefly, and he expanded on it, the culture of sort of borrowing and spending in this society. I think it is exacerbated. I think that is part of the story and I agree with him on that. I think it is exacerbated by how we have seen incomes go up at the top and incomes pretty stagnant for most Americans.

There was an interesting piece in the *Washington Post,* a front page piece today about CEO pay and how it is not really paying for performance anymore, and I was recently at a company—well, I will not go into that. But I have just seen that there is not the more spouses working, the decline in wages, how hard it is for somebody in the middle class now.

Anyone that wants to make additional comments may submit anything in writing in the next week. Appreciate Senator Corker being here always, and thank you, all seven of you, for your patience and your testimony and your insight and your public service. The Subcommittee is adjourned.

[Whereupon, at 4:37 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF ATIF MIAN

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OCTOBER 4, 2011

I thank the Senate Subcommittee on Financial Institutions and Consumer Protection for inviting me to talk about the role of household leverage in the current economic crisis and the importance of household balance sheets in explaining macroeconomic fluctuations. My discussion on this topic—which is based on my research over the years with Amir Sufi of University of Chicago Booth School of Business—is divided into three parts.

First, I discuss the magnitude and nature of household debt accumulation in the U.S. over the past decade. Second, I show how the timing and severity of the current economic collapse is closely related to the deleveraging of U.S. household balance sheets in the aftermath of the housing market downturn. Deleveraging by highly indebted households forces them to cut back on consumption. The resulting loss in aggregate demand is responsible for a majority of the jobs lost during the 2007–09 recession. Finally, I discuss the type of reforms needed to resolve the U.S. household leverage crisis and put the economy back on track.

Section 1: The Accumulation of U.S. Household Debt

The increase in household leverage prior to the recession was stunning by any historical comparison. From 2001 to 2007, household debt doubled from $7 trillion to $14 trillion (*see,* Figure 1). The household debt to income ratio increased by more during these 6 years than it had increased in the 45 years prior. In fact, the household debt to income ratio in 2007 was higher than at any point since 1929. Recent data suggest that over a quarter of mortgaged homes in the U.S. are underwater relative to their mortgage value.

Why did U.S. households borrow so much and in such a short span of time? What kind of households borrowed the most? I explore this question in a couple of papers with Amir Sufi (Mian and Sufi 2009 and 2011a). Our explanation for the increase in household debt begins with the dramatic expansion in mortgage originations to low credit quality households from 2002 to 2007. Mortgage-related debt makes up 70 to 75 percent of household debt and was primarily responsible for the overall increase in household debt.

We argue that the primary explanation behind the dramatic increase in mortgage debt was a securitization-driven shift in the supply of mortgage credit. The fraction of home purchase mortgages that were securitized by non-GSE institutions rose from 3 percent to almost 20 percent from 2002 to 2005, before collapsing completely by 2008. Moreover, non-GSE securitization primarily targeted zip codes that had a large share of subprime borrowers. In these zip codes, mortgage denial rates dropped dramatically and debt to income ratios skyrocketed.

An important lesson regarding mortgage expansion during the 2000s, is that the expansion does not reflect productivity or permanent income improvements for new borrowers. In particular, mortgage credit growth and income growth were negatively correlated at the zip code level from 2002 to 2005, despite being positively correlated in every other time period back to 1990. Mortgage credit flowed into areas with declining incomes at a faster pace.

One consequence of the rapid increase in supply of mortgage credit was its impact on house prices. As credit became more easily available to households that were historically rationed out of the credit market, house prices began to rise. Moreover, the increase in house prices was not uniform across the U.S. House price appreciated faster in areas that had difficult-to-build terrain, *i.e.,* where housing supply was inelastic. While this mechanism does not explain all of the cross-sectional variation in house price growth across the U.S., it does explain a major proportion of it. [1]

The increase in house prices had a large impact on further encouraging the accumulation of debt by households. In Mian and Sufi (2011a) we focus on the feedback effect from house prices to household borrowing by analyzing individual level borrowing data on U.S. household that already owned their homes in 1997 before mortgage credit expanded. We find that existing homeowners borrowed 25 to 30 cents against the rising value of their home equity from 2002 to 2006.

The home equity-based borrowing channel is strongest for low credit quality borrowers, borrowers with high credit card utilization rate, and younger borrowers. Moreover, home-equity borrowing was not used to purchase new properties or to pay

[1] In particular, cities in Arizona and Nevada are important outliers. *See,* Mian and Sufi (2009 and 2011a) for more details.

down expensive credit card balances, implying that the new debt was likely used for real outlays such as home improvement and consumption. Overall, we estimate that the home-equity based borrowing channel can explain 50 percent of the overall increase in debt among homeowners from 2002 to 2006.

To summarize, rapid increase in the supply of securitization-driven mortgage credit in early 2000s induced U.S. households particularly those in subprime neighborhoods to accumulate debt. The expansion in credit supply also fueled a remarkable increase in house prices and U.S. homeowners borrowed aggressively against the rising value of their houses. While overall debt increased by 7 trillion dollars, the increase was not uniform across the U.S. Household leverage growth was concentrated in areas with relatively inelastic housing supply, and among younger households and households with low credit scores.

Section 2: Household Deleveraging, Aggregate Demand, and Unemployment

A. The Beginnings of the Crisis

The accumulation of debt by households with largely stagnant real wages was not sustainable. Markets began to realize this towards the second half of 2006 as mortgage delinquencies crept up. In fact many of the first set of borrowers to default were those who could not even afford to carry their first few months of mortgage payments. Unable to refinance or sell their homes at a higher price, many homeowners began defaulting on their loan obligations.

Figure 2 plots the quarterly change in mortgage defaults and unemployment, and shows that default rates kept increasing for five straight quarters before there was an increase in the unemployment rate in the second quarter of 2007. This evidence is suggestive of the causal role that high household leverage and a weak housing market played in generating employment and output declines (*see,* Mian and Sufi 2010 for details). The next section shows more direct evidence of this channel.

B. Deleveraging and Aggregate Demand

How has the sharp rise in household debt from 2002 to 2007 affected economic recovery? When a large class of consumers see the value of their houses decline and realize that they can no longer rely on further borrowing to sustain their standard of living, they go into a "deleveraging mode". Deleveraging refers to the process where consumers stop relying on more credit for consumption and start making efforts to pay down existing debt to more manageable level. The scale of this problem can be judged from a recent study by Core Logic that reports that almost a quarter of homeowners who are current on their mortgages are underwater.

Once a large fraction of homeowners start cutting back on consumption as a result of deleveraging, there is a reduction in aggregate demand and the economy goes into a recession. Interest rates fall to help slowdown the fall in consumption and output. However, whether interest rate drop is sufficient to halt aggregate demand decline depends critically on the extent to which lenders (*i.e.,* savers) increase their consumption in response to declining interest rates. If—as has been the case in the current slump—even an interest rate of zero fails to boost consumption sufficiently for the lending class, aggregate demand will fall and the economy goes into a recession.

I explain below how this deleveraging—aggregate demand channel is responsible for the large drop in U.S. output and employment. As noted earlier, the accumulation of leverage across the U.S. differed widely, depending in part on the elasticity of housing supply in an area. There are thus important differences across the U.S. in the extent to which a given area has suffered from the deleveraging shock. These differences are illustrated in Figure 3 that comes from Mian and Sufi (2011c).

Figure 3 splits U.S. counties into four quartiles based on the debt to income ratio as of 2006. High (low) household leverage counties are counties in the top (bottom) quartile of the 2006 debt to income distribution. The top left panel shows that high household leverage counties experienced much more severe house price declines during the recession and afterward. House prices declined from 2006 to 2010 by 40 percent in these areas.

The decline in house prices represented a severe credit shock to households. As the top left panel shows, home equity limits from 2007 to 2010 declined by 25 percent in high leverage counties. The shock to credit availability translated into lower household borrowing. From 2007 to 2010, debt in these counties dropped by 15 percent, which translates into $600 billion.

The deleveraging shock also translates into aggregate demand. The lower right panel shows that consumption—as proxied by sale of new automobiles—drops significantly more in high leverage counties. High household leverage counties experienced a drop in auto sales of 50 percent from 2006 to 2009, with only a slight recovery in 2010. Mian, Rao, and Sufi (2011) show that the pattern in auto sales in Figure 3 also holds for consumption across other goods, including furniture, appliances, grocery, and restaurant spending. Moreover, within high leverage counties, the drop in auto sales is significantly higher in more subprime neighborhoods that are hit larger by the deleveraging shock.

The magnitude of the drop in these variables is far smaller in counties with low household leverage before the recession. As of 2010, house prices were down only 10 percent, home equity limits had dropped only 8 percent, and household borrowing was down only slightly relative to the 2008 peak. Auto sales dropped sharply even in low leverage counties, but the drop was much less severe and the recovery in 2010 is stronger.

C. Deleveraging and Unemployment

Figure 3 shows evidence of weak consumer demand for durable goods in high household debt counties. How does the sharp decline in consumption in high leverage areas affect aggregate unemployment? Answering this question with geographical variation has been difficult given an obvious barrier: the goods consumed in one part of the country are not necessarily produced in that area. For example, if Californians sharply reduce auto purchases because of excessive leverage, the decline in auto purchases will likely reduce employment in Michigan. Given this one only examines job losses in high leverage areas such as California.

However job losses in goods and services that are nontradable and hence must be produced in the city where they are consumed do not suffer from this problem. We therefore split consumption goods into those consumed locally (nontradable) and those consumed nationally (tradable), and use the impact of deleveraging shock on local nontradable employment to back out the total effect of deleveraging and reduced aggregate demand on employment (*see,* Mian and Sufi 2011c for details).

The central insight of our approach is that one can estimate the aggregate effect of household deleveraging on unemployment by examining how nontradable employment varies across counties with varying degrees of deleveraging shocks. We classify industries as nontradable if they are focused in the retail or restaurant business. Given that high leverage counties are those with a large boom and bust in residential investment, we explicitly remove construction from the nontradable sector. In other words, our nontradable industry category does not include construction or any other real estate related business.

The first step of the empirical methodology is to estimate the effect of deleveraging on employment in industries producing nontradable goods. The left panel of Figure 4 show a very strong and quantitatively large relation between household leverage measured as of 2006 and employment declines in nontradable industries from 2007 to 2009. For example, going from the 10th to the 90th percentile of county distribution by leverage increase job loss as a fraction of total employment in the county by 4.4 percentage points.

The right panel of Figure 4 repeats the analysis for employment losses in the tradable sector and shows that there is no relationship between county deleveraging shock and job loss in the tradable sector. The reason for this is that losses in the tradable sector are distributed equally across the U.S. as mentioned earlier. However, we can use the relationship between job losses and deleveraging shock in the nontradable sector to back out the number of nationwide jobs that have been lost in the tradable sector due to the deleveraging shock and resulting decline in demand.

We do this calculation carefully in Mian and Sufi (2011c) and perform a number of checks to ensure that the number we compute is driven by the deleveraging—aggregate demand phenomena and not any alternative explanation. The total number of job losses that we can conservatively attribute to the deleveraging—aggregate demand channel is staggering. We estimate that deleveraging of the household sector accounts for 4 million of the 6.2 million jobs lost between March 2007 and March 2009 in our sample. In other words, 65 percent of total jobs lost in the U.S. are due to deleveraging and the drop in aggregate demand as a result of it.

Section 3: Policy Choices

The analysis above identifies the deleveraging—aggregate demand channel as the most important mechanism responsible for economic downturn and job losses in the American economy. The sharp drop in consumer demand in areas that accumulated the most leverage and large employment losses associated with the drop in consumer demand highlight the economic importance of the deleveraging—aggregate demand channel.

Unfortunately the current deleveraging cycle in the U.S. is painfully slow. How long will this cycle last? Despite more than 3 years since the start of this cycle, the amount of debt paid off or written down remains stubbornly small. Out of the 7 trillion dollars accumulated over 2001–2007, only about one trillion has been paid down or written off. U.S. household balance sheets remain highly levered by historical standards. The most recent monthly auto sales data also continue to show significant weakness in consumer demand among high leverage counties.

In the face of the very slow deleveraging process and its high economic cost, we urgently need policies that help reduce leverage for highly indebted households without forcing them into costly actions such as bankruptcy and foreclosures.[2] The threat of foreclosure and losing one's home may force many underwater homeowners to continue paying their mortgage bills but the resulting drop in aggregate demand hurts everyone. Indeed most recent data from Core Logic suggests that a quarter of U.S. homeowners owe more than their house is worth, and yet continue to make mortgage payments.

The dilemma for efforts to reduce household indebtedness is that from a lender's perspective it is not in their interest to write down debt that continues to be serviced on time. But as my analysis highlights, the collective consequences of such "individually rational" actions are quite unpleasant. If a large number of financially distressed homeowners cut back on consumption in order to protect their homes and continue paying their mortgages, the aggregate demand and employment consequences hurt everyone.

An obvious policy proposal to facilitate leverage reduction is principal write-down on underwater mortgages. While the Government did initiate some related programs in the past, they have been largely ineffective in achieving the desired goal. To be sure, there are complicated legal issues pertaining to mortgage debt restructuring. Similarly any orderly mechanism of debt restructuring should minimize unwanted disruptions in the banking and financial system. These are difficult and complex problems, but not impossible to address and require collective regulatory and legislative action.

While the focus of my discussion has been the recent U.S. economic downturn, the relationship between high household leverage and long economic slumps is not limited to our current experience. In his seminal paper, Irving Fisher (1933) described the role that high household indebtedness and the process of deleveraging played in perpetuating the Great Depression. More recent empirical work by scholars such as Mishkin (1978), Olney (1999), and Eichengreen and Mitchener (2003) further supports this view of the Great Depression. Evidence from Japanese and European recessions (*e.g.,* King 1994) also highlights problems associated with leverage.

Our collective experience from historical recessions as well as the most recent global slump point to a fundamental weakness in the modern financial system: its inability to distribute downside risk equitably and efficiently across the population. The tendency to rely too much on debt-financed economic activity implies that in the event of a negative economywide shock, most of the financial pain is pushed on a particular segment of the population (*i.e.,* the borrowing class). As the recent U.S. experience reminds us, pushing most of the downside risk on one segment of the population is seriously damaging for the overall economy.

Going forward, in order to avoid deep economic slumps resulting from an overlevered household sector, we need to put in place contingencies that will automatically write down the value of outstanding debt if the overall economic environment is sufficiently negative. There is a lot to think through here before implementing a particular policy. However, it is practically feasible to redesign debt covenants by introducing contingencies for economic downturns.

For example, mortgage principal can be automatically written down if the local house price index falls beyond a certain threshold. Since such contingencies are written on aggregate states of nature, they do not suffer from the standard moral hazard criticism. Lenders will obviously price such contingencies in before extending credit, but it is a price that benefits borrowers and the economy in the long run. If we had such contingencies present in the current mortgage contracts, we could have avoided the extreme economic pain due to the negative deleveraging—aggregate demand cycle.

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[2] Foreclosures is a very costly mechanism to reduce indebtedness, especially in the current environment. In a recent paper, Mian, Sufi, and Trebbi (2011), we show that foreclosures significantly reduce the value of homes in the neighborhood of foreclosed home and lower house prices have a negative feedback effect on local consumption and investment.

Mervyn King, “Debt Deflation: Theory and Evidence,” *European Economic Review,* 38: 419–445, 1994.
Atif R. Mian and Amir Sufir, “The Consequences of Mortgage Credit Expansion: Evidence From the U.S. Mortgage Default Crisis”, *Quarterly Journal of Economics* 124: 1449–1496, 2009.
Atif R. Mian and Amir Sufir, “Household Leverage and the Recession of 2007 to 2009”, *IMF Economic Review,* 58: 74–117, 2010.
Atif R. Mian and Amir Sufir, “House Prices, Home Equity-Based Borrowing, and the U.S. Household Leverage Crisis”, *American Economic Review,* August, 2011a.
Atif R. Mian and Amir Sufir, “Consumers and the Economy, Part II: Household Debt and the Weak U.S. Recovery”, FRBSF Economic Letter, January 18, 2011, 2011b.
Atif R. Mian and Amir Sufir, “What Explains High Unemployment? The Deleveraging—Aggregate Demand Hypothesis”, Working Paper, 2011c.
Atif R. Mian, Kamalesh Rao, and Amir Sufi, “Deleveraging, Consumption, and the Economic Slump”, Working Paper, 2011.
Atif R. Mian, Amir Sufi, and Francesco Trebbi, “Foreclosures, House Prices and the Real Economy”, NBER Working Paper # 16685, 2011.
Frederic S. Mishkin, “The Household Balance Sheet and the Great Depression”, *Journal of Economic History,* 38: 918–937, 1978.
Martha Olney, “Avoiding Default: The Role of Credit in the Consumption Collapse of 1930”, *Quarterly Journal of Economics,* 114: 319–335, 1999.

Figure 1. Total Household Debt In The U.S.

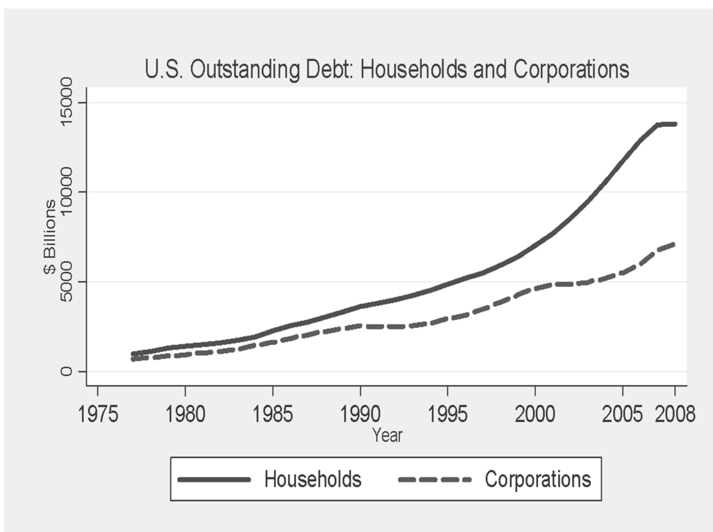


Figure 2. Household Defaults and Unemployment

The figure plot quarterly change in household mortgage delinquency rate and unemployment rate. Household default rate data come from Equifax and the unemployment data are from the Bureau of Labor Statistics.

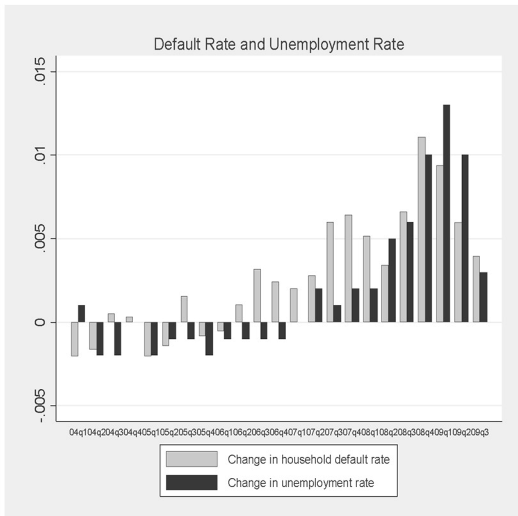


Figure 3

Deleveraging and Consumption

This figure plots house prices, home equity limits, household borrowing, and auto sales for high and low household leverage counties in the U.S. from 2006 to 2010. High and low household leverage counties are defined to be the top and bottom quartile counties based on the debt to income ratio as of 2006. Quartiles are weighted by the outcome variable in question as of 2006 so that both quartiles contain the same amount of the outcome variable as of 2006 (for house prices we weight by population).

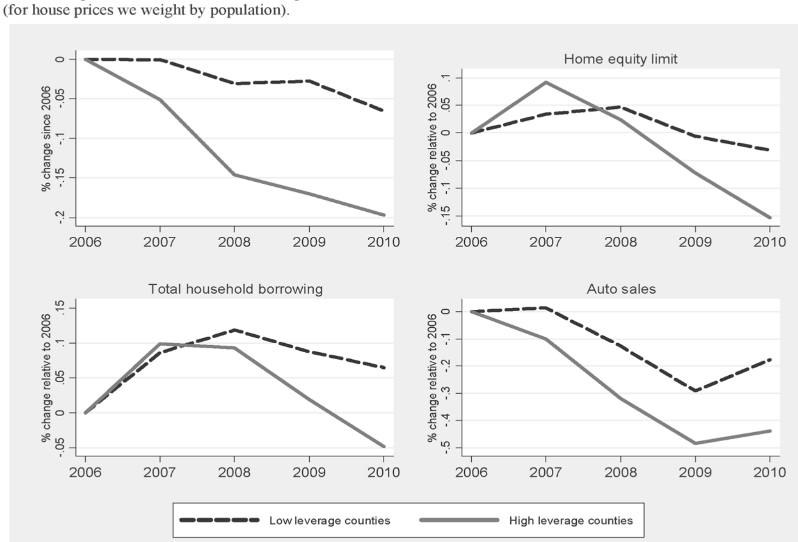
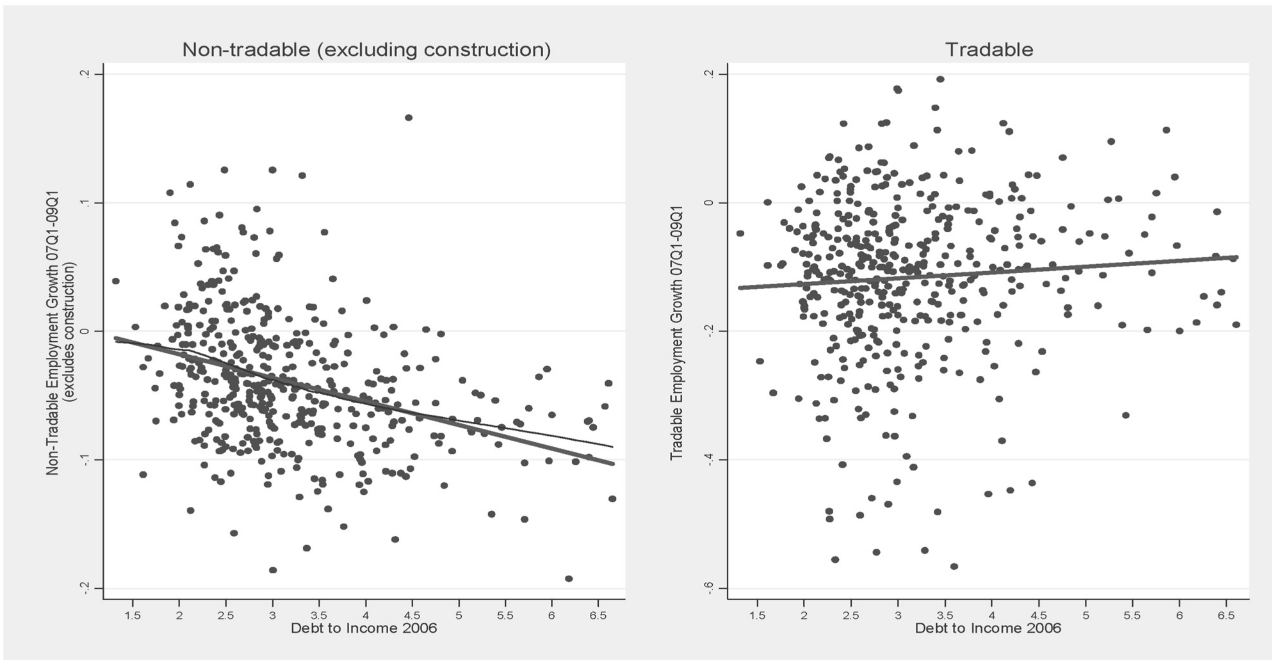


Figure 4

Deleveraging and Employment across Counties: Non-Tradable and Tradable Industries

This figure presents scatter-plots of county level employment growth from 2007Q1 to 2009Q1 against the debt to income ratio of the county as of 2006. The left panel examines employment in non-tradable industries excluding construction and the right panel focuses on tradable industries. The sample includes only counties with more than 50,000 households. The thin black line in left panel is the non-parametric plot of non-tradable employment growth against debt to income.



PREPARED STATEMENT OF KATHERINE PORTER

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OCTOBER 4, 2011

Introduction

My testimony addresses the reasons that thoughtful consumer protection is a vital necessity to our country's future economic health. In the last two generations, increases in household borrowing and changes in consumer financial services have reshaped the economy. The result is that consumer credit law will be a major determinant of the well-being of middle-class families for decades to come. To monitor this marketplace and its role in family economic security and the entire economy, lawmakers need the expertise and energy of a dedicated regulator on consumer credit such as the Consumer Financial Protection Bureau.

I am Professor of Law at the University of California, Irvine, School of Law. I have worked at several leading law schools, including Harvard Law School and the University of California, Berkeley, School of Law. I have conducted research on household economic security and consumer debt since 2001. My empirical research on abuses in the mortgage servicing industry was among the first efforts to document misbehaviors in foreclosure and bankruptcy cases that violate the rule of law. I am a principal investigator of the 2007 Consumer Bankruptcy Project, the Nation's largest study of families that file bankruptcy. I am the author of more than a dozen law review articles on consumer credit issues and am the editor of a forthcoming book, *Broke: How Debt Bankrupts the Middle Class* (Stanford Univ. Press, 2011).

Debt: The New Middle-Class Marker

The middle class is a powerful concept. Historically, the size and prosperity of the American middle class has been heralded as a great social and economic achievement. Membership in the middle class is associated with home ownership, educational opportunity, comfortable retirement, access to health care, and last but certainly not least, an appetite for consumer goods. [1] The middle class also has political appeal, as demonstrated by President Obama's decision during his very first week in office to establish a Middle-Class Task Force. [2] As chair of the task force, Vice President Biden explained that middle-class life is the "old-fashioned notion of the American Dream" and that he and the President "have long believed that you can't have a strong America without a growing middle class. It's that simple. It's that basic." [3] The task force has focused its energy on job creation, retirement security, work–family issues, and higher education. [4]

But the task force has largely ignored a revolutionary change in the lives of middle class Americans: the increase in household debt. In the mid-1980s, the ratio of debt to personal disposable income for American households was 65 percent. During the next two decades, U.S. household leverage more than doubled, reaching an all-time high of 133 percent in 2007. [5] Measured in the aggregate, the ratio of household debt to GDP reached its highest level since the onset of the Great Depression. [6] This record debt burden, which crested just as the financial crisis began, set up families to suffer deeply as foreclosures, unemployment, and wage stagnation set in for the years to follow.

The consumer debt overhang, however, began long before the financial crisis and recession. Exhortations about subprime mortgages reflect only a relatively minor piece of a much broader recalibration in the balance sheets of middle-class families. Debt began to climb steeply around 1985, with its growth accelerating in nearly

[1] Homi Kharas, "The Emerging Middle Class in Developing Countries", Working Paper no. 285 at 7, Organisation for Economic Co-operation and Development Centre, Washington, DC, 2010. *http://www.oecd.org/dataoecd/12/52/44457738.pdf*

[2] White House, "White House Announces Middle Class Task Force", Press Release, January 30, 2009. *http://www.whitehouse.gov/the-press-office/obama-announces-middle-class-task-force*

[3] White House, "Remarks by the President and Vice President at Middle Class Task Force Meeting", Press Release, January 25, 2010. *http://www.whitehouse.gov/the-press-office/remarks-president-and-vice-president-middle-class-task-force-meeting*

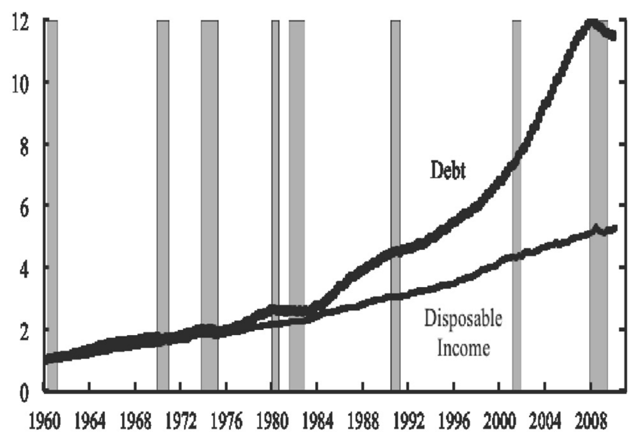
[4] Joseph I. Biden, "Annual Report of the White House Task Force on the Middle Class", Washington, DC: Office of the Vice President of the United States, 2010. Accessed August 16, 2010. *http://www.whitehouse.gov/sites/default/files/microsites/100226-annual-report-middle-class.pdf*

[5] Federal Reserve Bank of San Francisco, "U.S. Household Deleveraging and Future Consumption Growth", FRBSF Economic Letter 1, no. 2009-16 (May 15, 2009). Accessed October 2, 2011. *http:// http://www.frbsf.org/publications/economics/letter/2009/el2009-16.pdf*

[6] Atif R. Mian and Amir Sufi. "Household Leverage and the Recession of 2007 to 2009", Working Paper 15896 at 1, National Bureau of Economic Research, Cambridge, MA, 2010. *http://www.nber.org/papers/w15896*

every subsequent year until the onset of the recession. The run-up in consumer debt coincided with a period of deregulation of financial institutions and the preemption of State consumer protection laws and State usury laws that regulated interest rates. Unfortunately for American families, the debt binge was not accompanied by meaningful increases in disposable income. While income crept up, debt shot up, as Figure 1 illustrates. As debt grows relative to income, families must stretch their dollars further to pay for current consumption, while keeping up with debt payments. At some point, income simply becomes insufficient, and families must either curtail spending or default on debt. We are suffering these consequences now, as consumer spending stagnates and families shed debt through foreclosures and default.

Figure 1: *Real Household Debt and Income, 1960 to 2010*



Source: Federal Reserve Board of San Francisco Economic Letter, *U.S. Household Deleveraging and Future Consumption Growth* Number 2009-16 (May 15, 2009); updated data through Q1:2010 courtesy of Federal Reserve of San Francisco.

Note: All series normalized to 1960:Q1. Recession periods shown in gray.

The growth in debt outstripped the appreciation of assets during the last several decades. In other words, increases in liabilities—mortgage debt, home equity lines of credit, student loans, and credit cards—collectively grew faster than increases in assets—houses, cars, stocks, or cash savings. Edward Wolff of the Levy Economics Institute has calculated that as far back as 1995, the amount of mortgage debt began to increase faster than house values.[7] The result of the increased borrowing was to constrain or retard growth in household wealth. Indeed, between 2001 and 2004, the typical (median) American household's wealth actually declined.[8] This was an unprecedented event because the wealth decline occurred during a period of overall economic expansion.

For the middle class, household debt outstripped household asset accumulation. For households with wealth between the 20th and 80th percentiles of the entire distribution, the debt-equity ratio climbed from 37.4 in 1983 to 51.3 in 1998, and then topped off at 61 percent in 2004 and 2007.[9] Whether assessed against income or assets, debt grew in proportion to other changes in families' balance sheets. What

[7] Edward N. Wolff, "Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze—An Update to 2007", Working Paper no. 589 at 34, Levy Economics Institute, Bard College, Annandale-on-Hudson, NY, 2010. *http://www.levyinstitute.org/pubs/wp_589.pdf*

[8] *Ibid.,* 47, table 5.

[9] *Ibid.,* 50, table 8.

looked like a boom economy in the first half of the 2000s actually produced an increase in financial risk for families by loading them with unsustainable debt.

The expansion in borrowing spanned social classes, racial and ethnic groups, sexes, and generations. Every age group, except those 75 years or older, had increased leverage ratios between 1998 and 2007.[10] Similarly, African Americans, Hispanics, and non-Hispanic Whites all saw their leverage ratios grow from 2001 to 2007.[11] This is not to suggest that the debt explosion was equally distributed. For example, between 2004 and 2007, typical people who lacked a high school diploma and typical households headed by a person between ages 65 and 74 had particularly sharp increases in their debt burdens.[12] In particular periods, some groups saw modest declines in consumer debt, but the overwhelming trend was increased amounts of debt among nearly every type of family. By 2007, when debt burdens peaked, 77 percent of American households had some type of outstanding debt.[13] Consumer debt has become one of the most common shared qualities of middle-class Americans, usurping the fraction of the population that owns their home, is married, has graduated from college, or attends church regularly.[14]

Too Big to Fail and Too Small To Save: Families in the Recession

As debt increases, so too does the risk of financial failure. This is as true for American families as it is for large corporations, where the catchy phrase "highly leveraged" captures a profound tilt into the red on a balance sheet. The staples of middle-class life—going to college, buying a house, starting a small business—carried with them more financial risk in recent decades because they required more borrowing and new riskier forms of borrowing. The escalation in debt turned the smart financial decisions of the prior generation, such as purchasing a home or taking on student loans, into high-stakes economic gambles for middle-class families. Today, millions of Americans are losing those bets, struggling to avoid financial collapse.

One place to see the pain of overindebtedness is in the experience of bankrupt families. Over the long haul, increases in consumer debt seem to explain a significant portion of the increased numbers of consumer bankruptcies.[15] This year approximately 1.4 million families will file bankruptcy.[16] They will publicly "fall from grace," skidding down the economic spectrum.[17] These families' aspirations of middle-class security evaporated under pressure from debt collectors, looming foreclosures, and the loss of hope of earning their way out of their financial problems. At least for now, their version of the American Dream has been replaced by a desperate hope that things do not get even worse. Driven by debt, these families are at rock bottom.

Households that file bankruptcy have typically struggled seriously with their debts for the previous 1 to 2 years. In fact, many households spent months simply scraping together the money and paperwork needed to file a bankruptcy petition. Nearly all of these families will remember their few minutes with the bankruptcy trustee as one of the most painful moments of their lives. Bankruptcy is a head-

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[10] Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach, and Kevin B. Moore. "Changes in U.S. Family Finances From 2004 to 2007: Evidence from the Survey of Consumer Finances", Federal Reserve Bulletin 95, A37, table 12 (February 2009).

[11] Wolff, "Recent Trends in Household Wealth in the United States", 26.

[12] Bucks *et al.*, "Changes in U.S. Family Finances", A42.

[13] *Ibid.*, p. A37.

[14] In 2007, the U.S. home ownership rate was 68.1 percent. United States Census Bureau. "Housing Vacancies and Homeownership (CPS/HVS) Annual Statistics: 2007". Last revised February 20, 2008. *http://www.census.gov/hhes/www/housing/hvs/annual07/ann07t12.html*. As of 2007, 54.7 percent of American men and 51.2 percent of American women were married. United States Census Bureau. "America's Families and Living Arrangements: 2007". Accessed January 2, 2011. *http://www.census.gov/population/www/socdemo/hh-fam/cps2007.html.* In 2007, 27 percent of adults aged 25 or older reported having at least a bachelor's degree. Sarah R. Crissey. Educational Attainment in the United States: 2007. Washington, DC: U.S. Census Bureau, 2009. Accessed August 16, 2010. *http://www.census.gov/prod/2009pubs/p20-560.pdf.* A 2007 Gallup survey found that more than 40 percent of Americans claimed to attend church or synagogue regularly. Frank Newport. "Just Why Do Americans Attend Church?" Gallup, April 6, 2007. Accessed January 24, 2011. *http://www.gallup.com/poll/27124/Just-Why-Americans-Attend-Church.aspx.*

[15] Robert M. Lawless, "The Paradox of Consumer Credit", *University of Illinois Law Review* 2007 no. 1 361–362 (2007).

[16] Robert M. Lawless, "Bankruptcy Filings Dropping More Rapidly Than Expected", Credit Slips: A Discussion on Credit, Finance, and Bankruptcy (blog), September 9, 2011. *http://www.creditslips.org/creditslips/2011/09/bankruptcy-filings-dropping-more-rapidly-than-expected.html#more*

[17] Katherine Newman, "Falling From Grace 9", New York: Free Press, 1988.

on encounter with promises to pay that cannot be honored and privations suffered trying fruitlessly to make ends meet.

Millions of families suffer serious financial hardship but do not file bankruptcy. The number of foreclosures outstrips bankruptcy filings by nearly a two-to-one margin.[18] The Department of Education reported last month a Federal student loan default rate of 8.8 percent in fiscal 2009, and increase from 7 percent the previous year.[19] Last year, 140,000 people complained to the Federal Trade Commission about the tactics used by debt collectors, an increase of 28 percent from 2009.[20] A survey by RAND researchers found that between November 2008 and April 2010 39 percent of families had experienced one or more indicators of financial distress: unemployment, negative equity in their home, or being 2 months behind on their mortgage or in foreclosure.[21] Debt collection and default are not isolated experiences; they are becoming a routine part of the middle-class experience, albeit a painful one. The "new normal" of the U.S. economy—a world of layoffs and job losses, cuts in social programs, and continued housing depreciation—only means that more people will find themselves collapsing under the weight of debts incurred in brighter economic times.[22]

The experiences that are so evident in the wake of the recession highlight the fact that some people will lose the borrowing game that has become the American economy. The consumer spending that drove the economy at the end of the 20th century was not costless. It was bought and paid for with interest charges, late fees, increased stress about making ends meet, and sometimes, with the humiliation of bankruptcy. Increased consumption was largely financed by debt, rather than by increases in wages or appreciation of assets. Heavy household debt burdens ratchet up risk and reduce the security of the middle-class families.

The consumer debt phenomenon is not a temporary one; it will be a defining feature of American society for decades. It is a fact that consumer debt levels are going down. The "deleveraging" process of paying down debt and increasing savings that began in late 2007 has lasted 4 years and shows no signs of reversing. The Federal Reserve Board calculates the household debt service ratio for each quarter. This is an estimate of the ratio of debt payments on outstanding mortgages and consumer debt to disposable personal income. In 2011, the ratio declined to levels not seen since the late 1990s.[23] But these levels still remain far beyond those of the prior decades. Overindebtedness is declining but it is not a problem of the distant past, cured by the recession, Government stimulus programs, or the enactment of the Dodd-Frank financial reform law.

Retrenchment has been and will be painful—both for families and for lenders. For many families, it has meant homes lost to foreclosure, cars taken in repossession, trade-offs in family time for second jobs, and dunning from debt collectors. Opportunities to launch a new business, attend college, or start a family have been foregone. Changes in credit standards and fears about the consequences of credit have pushed many families further down the economic ladder, reducing assets and consumer confidence. Credit retrenchment, just like the increases in consumer credit in years before, dramatically reshapes the well-being of the middle class.

Consumer confidence is critically affected by consumer debt. The lack of access to credit that is a consequence of the financial crisis is making Americans pessimistic about their futures. In a September 2010 poll, only half of Americans agreed that "the American Dream—that if you work hard you'll get ahead—still holds true";

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[18] In 2010, Americans filed just over 1.5 million nonbusiness bankruptcies, compared to nearly 2.9 million foreclosure filings. Leslie E. Linfield, 2010 "Annual Consumer Bankruptcy Demographics Report: A Five Year Perspective of the American Debtor", 7n10, Institute for Financial Literacy. (September 2011) Accessed October 1, 2011. *http://www.financiallit.org/PDF/2010__Demographics__Report.pdf;* Julie Schmit "Joblessness Drove Foreclosures in 2010", *USA Today,* p. 6A (January 27, 2011).

[19] The default rate represents the percentage of student loans that fell into default among those whose payments were first due in the prior fiscal year. Kevin Helliker, "Student-Loan Defaults on the Rise", *The Wall Street Journal,* p. A2 (September 13, 2011).

[20] Federal Trade Commission, "Annual Report 2011: Fair Debt Collection Practices Act", 5 (March 2011). *http://www.ftc.gov/os/2011/03/110321fairdebtcollectreport.pdf.*

[21] Michael Hurd and Susan Rohwedder, "Effects of the Financial Crisis and Great Recession on American Households", Working Paper WR-810 at 27. RAND Corporation, Santa Monica, CA, 2010. *http://www.rand.org/pubs/working__papers/WR810.html*

[22] Nelson D. Schwartz, "Jobless and Staying That Way", *New York Times,* WK1, August 8, 2010. Accessed February 4, 2011. *http://www.nytimes.com/2010/08/08/weekinreview/08schwartz.html*

[23] Federal Reserve Board, "Household Debt Service and Financial Obligations Ratios", Last Updated September 20, 2011. *http://www.federalreserve.gov/releases/housedebt/*

more than 4 in 10 said it no longer did.[24] This middle-class discontent runs deep and retards efforts to stimulate economic growth. Americans are famously opportunity loving, but even back in 2005 during a robust economy, 62 percent favored the "stability of knowing your present sources of income are protected over concern with the opportunity to make money in the future," which attracted 29 percent of respondents.[25] Problems in managing consumer debt have increased economic anxiety.

Americans' appetite for risk and the aspirations of the middle class reflect in part the financial insecurity of consumer debt levels. With this type of uncertainty, the middle-class struggles to hang on, rather than propelling itself forward.

At a conference that I attended, someone quipped that while banks were "too big to fail," families were "too small to save." In part, this comment reflects the powerful importance of the risk frame in public policy, and that small incidences of harm rarely receive the attention of large ones—even if the accumulation of small harms dwarfs the single large harm. This preference to prioritize single large events over multiple smaller ones shortchanges middle-class families. For example, the Treasury's bold intervention in the capital markets is a stark contrast to its anemic response to foreclosures at the family level. Neither the Home Affordable Modification Program, nor the Government's most recent effort, the Emergency Homeowners' Loan Program, delivered on its promises, with delays in program roll-out and problems in administration. Overall, an estimated less than 1 million Americans have received a mortgage modification, refinance, or loan from these programs. In that same period, since 2007, over 2 million foreclosures have been completed. Today, estimates are that more than 6 million homeowners are delinquent on their mortgages and 16 million homeowners have no equity in their homes.

Americans are frustrated with the lack of an effective and sustained Government response to their financial hardships. Asked in mid-2010 whom Government had helped "a great deal" during the downturn, 53 percent of Americans said banks and financial institutions; 44 percent fingered large corporations. Just 2 percent thought economic policies had helped the middle class a great deal.[26] Middle-class Americans feel abandoned. Although their reactions range from anti-Government rhetoric to calls for more intervention, people are united across the political spectrum in feeling that Government's response to the financial crisis missed the mark. The lack of a Government regulator focused on consumer credit, including home ownership markets, is a likely contributor to the feeling that families are too often an afterthought in the design of economic policy.

From Subprime to Safe? Changing Financial Services

The debt loads that are commonplace among today's families would have been simply unthinkable a generation or two ago. While the recession that began in mid-2007 has widened the scope of the financial pain caused by overindebtedness, the problem predated the large-scale economic meltdown that captured headlines. Put another way, the bursting of the housing bubble and subprime loans are not the problem, or certainly not the entire problem, to be solved by consumer protection. The rising levels of household debt and the burdens they impose on families are not about a few bad actors or a couple of innovative loan products gone awry. Certainly, subprime loans and that market are poster children for the need for better oversight of consumer credit. However, they are only one part of a larger revolution in our economy that imposes more debt and more financial risk on families.

The receding financial crisis and the elimination of a subprime mortgage market do not mean that families today enjoy the economic security that traditionally characterized the middle class. Indeed, families today face a level of uncertainty about jobs, taxes, Government services, and credit access that leave them in uncharted territory. It is precisely in such an environment that consumer protection law can help families regain confidence in the American economy and make informed and smart financial decisions to build and protect their wealth.

A few examples illustrate the point. In the 1990s and first half of 2000s, home equity loans provided a solution for families who had unexpected expenses or a temporary loss of income. Those products are unavailable to homeowners who are un-

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[24] Holly Bailey, "ABC News/Yahoo! News Poll: People Are Losing Faith in the American Dream", **Yahoo! News,** September 21, 2010. Accessed January 30, 2011. *http://news.yahoo.com/s/yblog__upshot/abc-newsyahoo-news-poll-people-are-losing-faith-in-the-american-dream*

[25] Jacob S. Hacker, in Katherine Porter (ed.), "Broke: How Debt Bankrupts the Middle Class, 227", Stanford University Press, 2011 (citing The Tarrance Group and Lake Snell Perry Mermin and Associates, Battleground XXVII, 29. Washington, DC: George Washington University, 2006. *http://www.lakeresearch.com/polls/pdf/bg305/charts.pdf*).

[26] Hacker, *Broke, supra* n25, at 230.

derwater or who have limited equity. This reduction in home wealth leads families to look for other options, such as taking on increased student loans to pay for college rather than refinancing a house to pay tuition. Yet this alternative has its own risks; the generation graduating today and in upcoming years is more likely to have student loans and owe thousands of dollars more than their predecessors. This growing student loan market needs sustained attention and monitoring from the Government. Parents and children need financial education on these products and their consequences, and innovative in this market needs monitoring to protect against unfair or deceptive practices.

Another example of ongoing consumer protection issues is changes in retail banking and payment systems. Well before the effective date of the CARD Act in 2010,[27] younger people were more likely to prefer debit cards to credit cards.[28] The industry is rolling out new fees for debit cards, and mobile payments are growing in popularity. These changes mean consumers will have new choices and questions.

Similarly, the growth in debt among older Americans, combined with longer lifespans, mean that retirement is no longer synonymous with economic stability. Millions of seniors owe money on their mortgages, and this group is particularly likely to make use of credit cards. They are also targeted repeatedly in financial scams. As the baby boomers age and they enter retirement in financial positions quite different from the Greatest Generation, their behaviors and needs will change the financial profile of the middle class. These older Americans will look to the Government for education about consumer credit and will count on consumer protection laws to shield them from abusive practices that prey on older Americans.

In 2010, Congress created the Consumer Financial Protection Bureau (the "Bureau").[29] It is specifically charged with monitoring the functioning of the consumer credit markets. Already, the Bureau has developed outreach and education initiatives, perhaps most notably its work on servicemembers and their families. These efforts need to continue and accelerate to help families rebuild after the financial crisis. The Bureau may well have been effective in guarding against the harms of subprime lending but the bankruptcy of subprime lenders and the atrophy of the mortgage market does not eliminate the need for the Bureau. To the contrary, it is precisely in today's uncertain climate that families need a single, visible place to look for financial education.

In its lawmaking functions, the need is similar. Dozens of financial products, including credit cards, debit cards, and student loans are in transition in the wake of the recession and its aftermath. While Congress in Dodd-Frank and the Federal Reserve in its rulemaking have addressed some aspects of the mortgage market, the future of home ownership remains unsettled. We do not know if the 30-year fixed loan will emerge as the sole mortgage product or if a variety of products will proliferate; the market and the regulation of the market will work together to determine these answers. The lesson of the subprime loan market is that there is a grave danger that the Federal Government will pay insufficient attention to consumer credit markets without a dedicated regulator, and that families and the entire economy can suffer as a result. Families need a powerful voice in these conversations that focus on their well-being; the checks and balances that Congress built into the Bureau's design ensure that financial institutions—and their traditional regulators—will also have a voice in determining the future of consumer credit law. That is entirely proper in my opinion. We should guard against weakening the Bureau now that the worst of the financial crisis may be against us. The uncertainty of the future makes the Bureau even more necessary than during the height of the financial crisis when policy makers were focused on acute problems. Government needs to continue to engage in monitoring and regulating consumer credit to help the economy recover and rebuild middle-class wealth.

Protecting Middle-Class Prosperity

Today, millions of middle-class families are experiencing deep economic pain. Consumer debt is not the only reason for the increasing financial vulnerability of Americans; stagnant wages, increased volatility in the labor market, health care and college costs that outpace inflation, and longer life spans that strain retirement savings all play a role. Consumer debt is a powerful force that affects middle-class pros-

[27] Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (2010).

[28] Ronald J. Mann, "Adopting, Using, and Discarding Paper and Electronic Payment Instruments: Variation by Age and Race", May 2011. Fig. 7.14 (finding that consumers over the age of 45 appear significantly less likely to use debit cards, controlling for race, household status, income, and education).

[29] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, §1001 (2010).

perity, however, because in the last two decades debt was the crutch of families wounded by other economic harms. Debt smoothes consumption over time; for example, it can ease the uneven income that characterizes the rising cadre of temporary and contract workers in America. Debt substitutes for cost controls in markets gone astray; for example, people increasingly must finance medical bills because they overwhelm their monthly budgets. Debt fills gaps in making ends meet when social programs erode; for example, people may borrow from a payday lender to cover utility bills as local governments eliminate energy subsidy programs.

These functions for debt are not inherently bad. To the contrary, debt has long been a lynchpin of opportunity in our society. But too many Americans have borrowed too much and that they taken on debts that worsened, rather than improved, their financial situations. In bankruptcies, foreclosures, economic anxiety, and joblessness, we see the harms of consumer debt. The cost of debt is not just the annual percentage rate charged to a family. It is also the social costs of some borrowers becoming hopelessly mired in debt and the macroeconomic effect of overleveraged households. Those costs are being paid by today's middle-class families during the recession and will likely continue to be paid in the upcoming decade. Economic models show that lowering the debt-to-income ratios of households in the next decade and beyond will have significant changes on the macroeconomy and its ability to grow through increased consumption.[30] The cumulative result of households' debt burdens is to create a drag on economic growth for the entire Nation.

America's relationship with borrowing is at a turning point. Lenders have tightened underwriting standards, and households are reducing their spending and saving more of their incomes. The open question is whether this retrenchment will endure or accelerate. Will America reverse more than two decades of reliance on consumer borrowing and gradually work its way back to debt burdens of the post-War period of prosperity? Or will the borrowing habit return in a few years as the recession recedes, with another boom in borrowing replacing the last few years of bust? The choice between those paths has profound consequences for the economic security of America's middle class.

Congress continues to consider ways to help families with bills such as the Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011, but it should not have to act alone. The executive branch needs to contribute expertise and administrative support. The Bureau is a crucial part of helping to navigate the future of our economy. Through research, rulemaking, and education, the Bureau will provide a roadmap for legislative activity and consumer decision making. It can respond nimbly to the rapid changes that are common in today's turbulent economy and it can help consumers stay informed of changes to markets and laws that could aid them in rebuilding and maintaining wealth.

The Bureau's central mission is to nurture the marketplace for consumer credit, and it's time to allow it to begin its work in earnest by confirming a permanent director and putting to rest efforts to redesign the carefully crafted structure of the Bureau that Congress approved only a year ago. The uncertainty about credit markets is worsened by efforts to dismantle or defang the Bureau. Institutions and industry need a clear path forward, and they need a place to bring concerns about the future of consumer protection regulation. A fully operational Bureau allows families and institutions to adapt and to begin to recover in the wake of the recession and new pressures on families' financial well-being.

Conclusion

Going forward, our Nation cannot afford to adopt a blind belief that consumer credit markets require little attention. The unmanageable debt burdens that pushed us into a recession and are hampering our recovery powerfully demonstrate that more debt does not equal more prosperity. We cannot sustain national economic prosperity while unmanageable borrowing undermines the prosperity of American families. But neither can we afford to limit opportunity and shunt upward mobility for the middle class by buying into fear that all borrowing is bad or accepting an endless downward spiral of consumer credit. The challenge is to figure out how to calibrate consumer credit markets to balance the harms of borrowing against its benefits. The Consumer Financial Protection Bureau is a critical aspect of meeting that challenge. Its vitality will help our economy recover and flourish, and its vigilance in the future will safeguard the well-being of American families as consumer debt markets change.

[30] Federal Reserve Bank of San Francisco, "U.S. Household Deleveraging", *supra* n5, at 3.

PREPARED STATEMENT OF ROBERT M. LAWLESS

PROFESSOR OF LAW, UNIVERSITY OF ILLINOIS COLLEGE OF LAW

OCTOBER 4, 2011

Congress created the Consumer Financial Protection Bureau (CFPB) to put an end to lending practices that rely on consumer confusion to create profits for the lenders. Although the CFPB has now come into existence, partisan politics have hampered the CFPB's ability to fully vindicate its statutory mandate. The Senate has yet to act on the confirmation of a permanent director, and some members of Congress have vowed to scale back the agency's powers. Thank you for inviting me here today. In my testimony, I will describe the problems that led Congress to create the CFPB in the first place and how these problems continue to plague American consumers.

I am a professor of law and codirector of the Illinois Program on Law, Behavior and Social Science at the University of Illinois College of Law. In my courses and research, I study the problems that lead both consumers and businesses into financial distress and how we as a society react to financial distress. Along with seven other scholars, including copanelist Professor Katherine Porter, I regularly contribute to Credit Slips *(http://www.creditslips.org)*, a blog that discusses issues related to credit, finance, and bankruptcy. My testimony today draws on what I have learned as a scholar and teacher of lending and bankruptcy. The views I am expressing are my own and not necessarily the views of my university or any other organization with which I am affiliated.

A Middle-of-the-Road Agency

I am here today as someone who was skeptical about the creation of a consumer financial agency. [1] My skepticism stemmed not from the oft-repeated concerns over an agency that has too much authority. Rather, my concern was that a consumer financial agency did not go far enough. Professor Warren framed her proposal for a consumer financial agency largely in terms of informational problems between consumers and lenders. [2] Under this vision, plain English disclosures would ameliorate many of the most abusive lending practices. In Professor Warren's words, "the basic premise of a market is full information." The agency would stand in the middle between consumers and lenders to ensure consumers were acting with full information.

Although providing consumers with more information is a laudable goal, many consumer lending transactions simply transfer wealth away from persons living at the economic margins of society and put this wealth in the pockets of large financial institutions. If we decide as a society that these wealth transfers are intolerable, the answer is not to surround these transactions with more information but to ban these transactions altogether. Vigorous and effective usury caps would put an end to predatory lending at rates approaching a 300 percent or 400 percent APR. If, for example, consumers systematically make mistakes to choose credit cards with low teaser rates but higher long-term costs, then the answer is to limit the use of teaser rates.

At the time of Dodd-Frank, people of good judgment and good faith differed on what Congress should do to prevent a repeat of the consumer lending abuses that played a role in creating the financial crisis. In the heated rhetoric that often surrounds any discussion of the CFPB, it has been forgotten that the agency in many ways was a compromise solution between those who wanted to go further and those who thought no little or new regulation was necessary.

My other reason for skepticism was the problem of regulatory capture. In legal and political science scholarship, "regulatory capture" describes a situation where an administrative agency becomes beholden to the interests it regulates. The agency begins to act on behalf of those interests instead of the citizenry. Regulatory capture can happen for institutional reasons such as the fact that the regulated companies often have the greatest incentive to monitor and lobby the administrative agency. Cultural forces also play a role as agencies often draw their employees from the same labor pool as do the companies they regulate or as agency employees come to know their counterparts in the regulated industry.

In financial regulation, regulatory capture has been particularly acute. The Office of the Comptroller of the Currency (OCC) draws its budgets from the fees of the

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[1] The Limits of Contract as Product, 157 *U. Pa. L. Rev. PENNumbra* 160 (2009) (available at *http://www.pennumbra.com/responses/02-2009/Lawless.pdf*).

[2] Oren Bar-Gill and Elizabeth Warren, "Making Credit Safer", 157 *U. Pa. L. Rev.* 1 (2008); Elizabeth Warren, "Unsafe at Any Rate", *Democracy: A Journal of Ideas,* Summer 2007, at p. 8.

banks it regulates. Many observers have noted the OCC often seems to act in ways that attract regulatory business and hence higher fees and bigger budgets.[3] Commentators made similar observations about the Office of Thrift Supervision (OTS), an agency eliminated by Dodd-Frank.[4] In their article proposing a consumer financial agency, Professors Bar-Gill and Warren described a broad failure across a number of agencies to regulate on the behalf of consumers: the Federal Reserve, the OCC, the OTS, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Federal Trade Commission.[5]

To minimize the risk of regulatory capture in an area that had proven so susceptible to it, Congress tried to insulate the CFPB from political influences. As the Subcommittee is undoubtedly aware, there have been innumerable proposals to tear down the structures that protect the CFPB from interest-group politics. Efforts to replace the one-person director of the CFPB with a commission or place the CFPB's budget under the immediate control of Congress are steps in the wrong direction. Indeed, the very existence of these efforts, largely centered in the financial services industry, demonstrates the need for vigilance in keeping the CFPB a truly independent agency. In an era of permanently indebted private households and complex financial instruments that provide opportunities for abuse at the expense of everyday Americans, we need an effective CFPB that will not be the hand maiden of the industries it needs to regulate.

An Indebted Society

Congress did not design the CFPB as an "anti-debt" agency. Used properly, borrowing can be an effective financial strategy for many consumers. Many Americans pay for their homes, their cars, and their educations through well-considered decisions to borrow money. Individually, many of these borrowing decisions undoubtedly made sense. In the aggregate, however, these individual decisions have made America an indebted society with remarkably high levels of household debt. The rush by financial institutions to supply this debt played a role, if not the major role, in creating our current financial crisis. An effective CFPB not only can minimize the systemic risk that comes from high levels of household debt but also act to minimize the harm that can befall individual borrowers when they enter into borrowing decisions they do not understand or cannot possibly afford.

Without question, the financial crisis has reduced the amount of outstanding consumer debt. According to the Federal Reserve, consumer debt has shrunk by 4.2 percent since the beginning of 2008 to July 2011 (the most recent data available).[6] This small reduction in consumer debt is a drop in the bucket compared to the massive run-up during the past several generations. Even after adjusting for inflation and population growth, consumer debt has risen 46 percent in the past 25 years and 106 percent in the past 50 years. When mortgages are considered, private household debt has increased 220 percent in the past 25 years and a staggering 374 percent in the past 50 years. Many Americans now spend most of the adult lives owing debts to some financial institution.

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[3] Adam Levitin, "Why the OCC Can't Be Relied on for Consumer Protection", Credit Slips (Aug. 21, 2008) *(http://www.creditslips.org/creditslips/2008/08/why-the-occ-can.html)*; Stephanie Mencimer, "No Account: The Nefarious Bureaucrat Who's Helping Banks Rip You Off", The New Republic, Aug. 27, 2007, at 14 (*http://www.tnr.com/article/no-account*); Alan White, "OCC Findings: Illegal Foreclosures, Critical Deficiencies", Credit Slips (Feb. 17, 2011) *(http://www.creditslips.org/creditslips/2011/02/occ-finds-illegal-foreclosures-critical-deficiencies.html)*.

[4] U.S. Senate Permanent Subcommittee on Investigations, Staff Report, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse", pp. 161–242 (Apr. 13, 2011) *(http://hsgac.senate.gov/public/__files/Financial__Crisis/FinancialCrisisReport.pdf)*; Robert Cyran, "The Downfall of a Regulator", *N.Y. Times,* Apr. 8, 2009, at B2 *(http://www.nytimes.com/2009/04/09/business/09views.html)*.

[5] Oren Bar-Gill and Elizabeth Warren, "Making Credit Safer", 157 *U. Pa. L. Rev.* 1, 86–97 (2008).

[6] Federal Reserve Statistical Release G.19 (July 2011). The term "consumer debt" does not include mortgages.

Total Household Debt Per Capita (2009), OECD Countries
adjusted to U.S. dollars
Figure 1

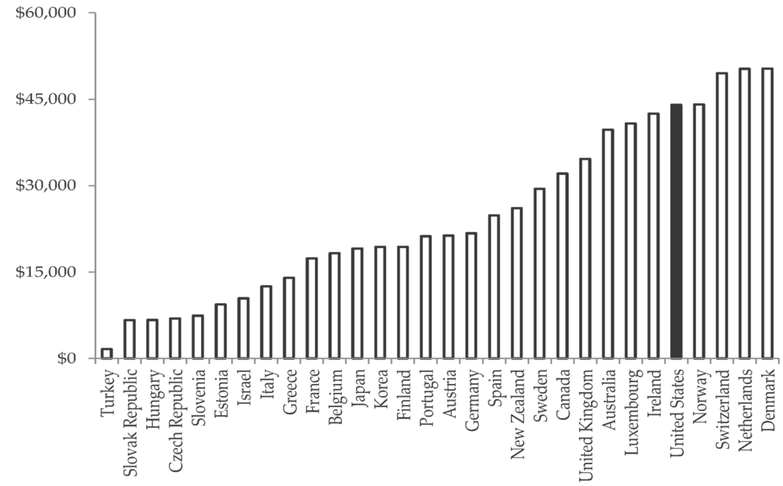

Figure 1 shows per capita total household debt, adjusted to U.S. dollars, for OECD member countries. Data are from 2009, which is the most recent year available for most countries. All data, including population data, come from the OECD's *StatExttracts* web site (http://stats.oecd.org/Index.aspx). Adjustment into U.S. dollars was done with the OECD's series on purchasing power parity (PPP) for private individual consumption. Household debt includes both short-term and long-term loans, including home mortgages. Countries for which no data were available are omitted.

Compared to other countries, Americans are a deeply indebted people. According to the most recent data from the Organization for Economic Co-operation and Development (OECD), Americans had total household debt of $44,041 for every man, woman, and child in the country, the fifth highest among all OECD countries as illustrated by Figure 1. Adjusting for population allows for comparison across borders. Using per capita figures, however, understates the true debt burden because not every man, woman, or (especially) child has outstanding debt. For the average person carrying debt, the burden is much higher than $44,041.

Short-Term Household Debt Per Capita (2009), OECD Countries
adjusted to U.S. dollars
Figure 2

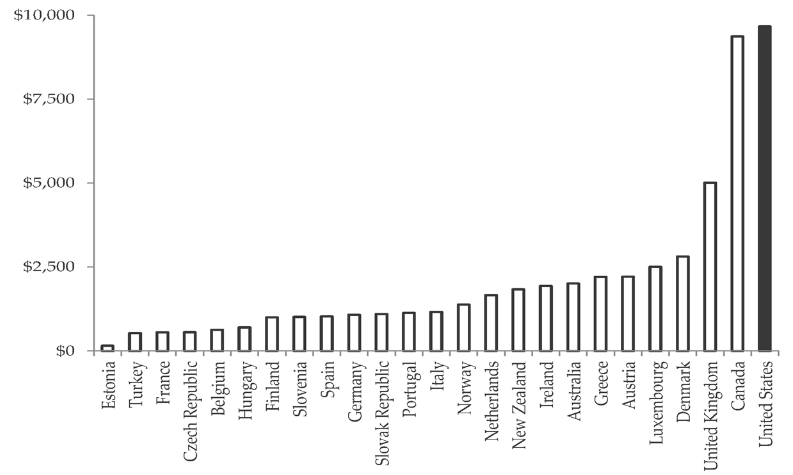

Figure 2 shows per capita short-term household debt, adjusted to U.S. dollars, for OECD member countries. Short-term household debt is debt loaned for a term of less than one-year and includes credit card debt as well as nonrevolving debt loaned on a short-term basis. All data, including population data, come from the OECD's *StatExttracts* web site (http://stats.oecd.org/Index.aspx). Adjustment into U.S. dollars was done with the OECD's series on purchasing power parity (PPP) for private individual consumption. Countries for which no data were available are omitted.

When considering just short-term household debt, the United States leads all OECD countries with $9,663 owed per capita. The OECD defines short-term debt as any debt loaned for less than 1 year. Long-term debt is debt loaned for periods of greater than 1 year with the biggest components of long-term debt being home mortgages and automobile loans. Short-term debt is typified by credit card debt and payday lending. Thus, consumers are much more likely to be using short-term debt for immediate consumption. It is exactly these types of borrowing decisions where consumers are more likely to act quickly, perhaps under some pressure and without careful shopping among different lenders. It is exactly these types of borrowing decision where lenders can exploit consumer confusion and lack of information. It is exactly these types of borrowing decision where the CFPB can be most effective. And, it is exactly these types of borrowing decision in which Americans lead the world.

Household Debt, Bankruptcy, and the CFPB's Role in Research

In its invitation, the Subcommittee asked for my views on "the role of consumer financial products in contributing to excessive household indebtedness and, in the extreme, bankruptcy." Part of that question is easy to answer, and part of that question is much more difficult to answer. After explaining the easier part of the answer, I will turn to how the CFPB would be incredibly helpful in answering the more difficult part of the question.

The easier part of the answer is that excessive household indebtedness clearly has a link to bankruptcy filings. [7] In the short run, the link is counterintuitive. As consumer debt increases, bankruptcy filings generally decline in the short-term. When consumer debt is more readily available, households can stave off the day of reckoning by borrowing to pay for rent, medical expenses, groceries, and the other necessities of daily life. A tightening of consumer debt generally has the opposite effect, driving more people into bankruptcy in the short term. When its effects are measured over a long run, however, consumer debt does lead to increased bankruptcy

[7] This discussion is based on my findings in Robert M. Lawless, "The Paradox of Consumer Credit", 2007 *U. Ill. L. Rev.* 347. Further discussion appears at Bob Lawless, "One More Time With Feeling", *Credit Slips* (Aug. 22, 2011) *(http://www.creditslips.org/creditslips/2011/08/one-more-time-with-feeling.html)* and Bob Lawless, "Debt Causes Bankruptcy (But Sometimes in Counter-Intuitive Ways)", *Credit Slips* (Jan. 7, 2011) (*http://www.creditslips.org/creditslips/2011/01/debt-causes-bankruptcy-but-sometimes-in-counter-intuitive-ways.html*).

rates. Because of its relationship to consumer debt, the bankruptcy filing rate can rise even during economic boom times such as the 1990s when earlier increases in debt created long-term conditions conducive to bankruptcy filings that then spiked when credit markets became more difficult for consumers to access. Another example is this year, where bankruptcy filings will fall about 10 percent even amidst a dire economy. The dearth of new consumer debt in the immediate wake of the financial crisis in 2007 and 2008 created a situation where there would be less long-term need for bankruptcy. As consumers have found it slightly easier to borrow this year, the conditions have been created for a decline in this year's bankruptcy filing rate. Thus, contrary to popular wisdom, it is consumer indebtedness, not the Nation's overall economy that plays the major role in driving the Nation's bankruptcy filing rate.

The more difficult part of the Committee's question is the role particular consumer financial products play in creating excessive household indebtedness. Once a consumer gets to bankruptcy court, the fact of the bankruptcy filing and the consumer's circumstances become a matter of public record. Researchers can use this information to understand the relationship between indebtedness and bankruptcy, as we have done, for example, in documenting how Americans are arriving in bankruptcy much further in debt than they did 30 years ago.[8] As to how people become overindebted in the first place, we have a much poorer understanding. For example, is overindebtedness often due to exogenous shocks like illness or job loss, or are poor purchasing decisions and overconsumption the primary driver? To what extent does culture or other attitudes drive overindebtedness? Are particular consumer financial products more likely to lead to overindebtedness? Are some consumer financial products inherently abusive in that they cost far more than any conceivable benefit they could be giving the borrower? The data that would provide some insight into these questions generally is private and beyond the ability of independent researchers to investigate.

Often lost in the debates over the CFPB is the research function Congress directed it to have. Following the statutory directive given by its enabling legislation, the CFPB now has a research unit that investigates the following issues:

A. Developments in markets for consumer financial products or services, including market areas of alternative consumer financial products or services with high growth rates and areas of risk to consumers;

B. Access to fair and affordable credit for traditionally underserved communities;

C. Consumer awareness, understanding, and use of disclosures and communications regarding consumer financial products or services;

D. Consumer awareness and understanding of costs, risks, and benefits of consumer financial products or services;

E. Consumer behavior with respect to consumer financial products or services, including performance on mortgage loans; and

F. Experiences of traditionally underserved consumers, including un-banked and under-banked consumers.[9]

The CFPB's resources and access to data will make its research division a hub for top-flight independent scholars who are trying to work together to understand how and why consumers become overindebted. Although good consumer finance research is happening in some Federal agencies, most notably the Federal Reserve, these research departments understandably exist to serve the important regulatory aims of their sponsoring unit such as banking regulation. In contrast, the research arm of the CFPB works within an organization whose mission it is to further consumer protection. Instead of research that focuses on how consumer finance might affect other regulated systems, the CFPB will produce research that understands how consumer finance affects consumers. In a few years, we should have a much better understanding of whether particular financial products are most likely to lead to overindebtedness.

More Than Just Outstanding Consumer Debt

It was not just rising consumer debt that led Congress to create the CFPB. Committees such as this one had heard Americans complain for years about abusive practices in mortgage lending, credit card lending, arbitration, debt collection, mortgage servicing, payday loans, and many other industries. The financial crisis of 2008

[8] Robert M. Lawless, Angela Littwin, Katherine Porter, John Pottow, Deborah Thorne, and Elizabeth Warren, "Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors", 82 *Am. Bankr. L. J.* 349 (2008).

[9] 12 U.S.C. §5493(b)(1).

created a climate in which the political will finally existed to protect consumers from practices where companies profited, not by providing a better product, but by deception, confusion, and lack of information. With the collapse of the subprime lending market, it is tempting to think that abusive practices around consumer financial products have disappeared and that the need for an organization like the CFPB has diminished. Since the CFPB was created, new problems have appeared, and old problems have become salient in new ways. At the risk of creating the misimpression that the challenges are limited by mentioning only a few specific problems, I will list three current areas of concern in which an effective CFPB could play a role.

Reverse mortgages allow older persons to draw on equity they have in their homes and receive a stream of payments to help with expenses in their retirement years. To make an informed decision on a reverse mortgage, a consumer needs a good understanding of the value of the home, life expectancy, and a competitive interest rate. All of these pieces of information require estimation. Moreover, we can expect consumers to display bias in making these estimates such as overestimating the value of the home or life expectancy. In addition, persons contemplating a reverse mortgage often have liquidity constraints that create pressure to agree to the reverse mortgage. Some of the same players in the subprime lending market have moved into reverse mortgages, leading to complaints from consumer advocates that were similar to the complaints about subprime lending. Reports of high fees and financial products inappropriate for the consumer are becoming more and more frequent in the reverse mortgage industry, which seems poised to become the next big consumer lending problem area.

Mortgage servicing problems have dominated the news. Borrowers and even their attorneys are unable to reach a person at mortgage servicers who can negotiate a reasonable solution. Paperwork mailed to servicers gets lost or goes unacknowledged. Court affidavits have been mass-produced and signed by persons with little knowledge over the facts alleged in the affidavit, a problem now known as "robo-signing." Community-based foreclosure mediation programs founder for want of funds and participation by both borrower and lender. Foreclosed properties, wanted neither by the bank or the homeowner, sit vacant and become a blight on the urban landscape.

Finally, debt collection abuses appear to be becoming more prevalent. Credit card collections may have replicated the robo-signing problems in the mortgage servicing industry. Indeed, given that many of the same players are involved and that credit card debt is sold in ways that is similar to mortgage debt, it would be surprising if the debt collection industry did not have robo-signing problems. Other debt collectors have left families who have lost relatives with the incorrect impression that the family is legally responsible for the debts of their deceased loved one. In some areas, reports have surfaced that creditors act in concert with local courts to abuse procedures known as "body attachments" where a debtor can be arrested for failure to answer interrogatories related to a debt collection. When called into court, the technical nicety of being arrested for failure to answer interrogatories, as opposed to nonpayment of the debt, is lost on the debtor. Instead, the creditor or the court will tell the debtor he or she can go free if the debtor starts making payments on the debt.

Abuses in reverse mortgages, mortgage servicing, and debt collection are just a few of the current problems that demonstrate how a comprehensive Federal regulator can help protect consumers. Responsible companies in these industries should welcome the oversight of the CFPB to rid the industries of bad actors. Three years into the financial crisis, it can be easy to forget the conditions that led to the creation of the CFPB. It is important that short political memories not hobble an important tool for American consumers just after it starts.

PREPARED STATEMENT OF RAY BOSHARA

SENIOR ADVISOR, FEDERAL RESERVE BANK OF ST. LOUIS

OCTOBER 4, 2011

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, thank you for the invitation to appear before you today. My name is Ray Boshara, and I am a senior advisor at the Federal Reserve Bank of St. Louis. Let me state that the views expressed here today are my own views, and not necessarily the views of the Federal Reserve Bank of St. Louis or the Board of Governors of the Federal Reserve System.

At the Federal Reserve Bank of St. Louis, I am organizing a new effort to study mechanisms that promote household financial stability, with a particular emphasis on rebuilding the balance sheets and net worth of American households. My work is focused on families hardest hit by the financial crisis and the economic downturn, those who have experienced significant losses of employment, income, and wealth. We know that balance sheets matter because financially healthy families spend, save, and invest more, and thereby contribute to economic growth.

My testimony is in two parts. In the first part, I discuss why a focus on household balance sheets is necessary. And in the second part, I offer some policy recommendations, based on my own work, to help rebuild the balance sheets of struggling families.

Why Balance Sheets Are Important

Balance sheets, by which I mean the savings, assets and debts of households, merit attention for three reasons. First, over the past few years we have all seen the damage to families, communities, and the broader economy derived from balance sheet challenges. For too many years, household debt levels rose, eventually to dangerous levels, while little was done to build up household savings and to diversify family assets beyond housing. When the housing bubble burst, the wealth of many households plunged, leaving balance sheets, according to some economists, at a historic low.[1] For instance, Mian and Sufi report that both household debt-to-income and household debt-to-assets ratios reached their highest points since 1950, with the debt-to-income ratio skyrocketing from 2001 to 2007 by more than it had in the prior 45 years.[2]

While balance sheets have improved somewhat in the last couple of years, financial instability remains severe among the poor and persons of color, and reaches into the middle class. Consider these points:

- Three-fifths or more of families across all income groups, according to the 2009 Survey of Consumer Finances (SCF) of the Federal Reserve, reported a decline in wealth between 2007 and 2009, and the typical household lost nearly one-fifth of its wealth, regardless of income group.[3]
- The Pew Research Center finds that, in 2009, typical net worth stood at $5,677 for blacks, $6,325 for Hispanics, and $113,149 for whites. About a third of black and Hispanic households had zero or negative net worth that year, compared with 15 percent of white households.[4]
- Almost half of all households surveyed in the 2009 SCF had less than $3,000 in liquid savings, and 20 percent had less than $3,000 in broader savings.[5]
- Nearly half of all Americans consider themselves financially fragile, meaning that they would "probably" (22.2 percent) or "certainly" (27.9 percent) be unable to come up with $2,000 in 30 days to cope with a financial emergency.[6] Similarly, almost half of all Americans report having trouble making ends meet.[7]
- In a survey by Holtz, Van Horn, and Zukin on the effects of unemployment and the recession, 70 percent of workers reported withdrawing funds saved in college and retirement accounts in order to make ends meet,[8] likely leading to losses of wealth in future years.

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[1] Atif Mian and Amir Sufi, "Household Leverage and the Recession of 2007–09", *IMF Economic Review,* vol. 58 (1), pp. 74–117, 2010. *www.palgrave-journals.com/imfer/journal/v58/n1/pdf/imfer20102a.pdf*

[2] Mian and Sufi, "Household Leverage and the Recession of 2007–2009".

[3] Jesse Bricker, Brian Bucks, Arthur Kennickell, Traci Mach, and Kevin Moore, "Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009", Finance and Economics Discussion Series 2011-17 (Washington: Board of Governors of the Federal Reserve System), 2011. *www.federalreserve.gov/pubs/feds/2011/201117/201117abs.html*

[4] Rakesh Kochhar, Richard Fry, and Paul Taylor, "Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics", (Washington, DC: Pew Research Center, July), 2011. *http://pewsocialtrends.org/files/2011/07/SDT-Wealth-Report_7-26-11_FINAL.pdf*

[5] Bricker, Bucks, Kennickell, Mach, and Moore, "Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009".

[6] Annamaria Lusardi, Daniel Schneider, and Peter Tufano, "Financially Fragile Households: Evidence and Implications", *Brookings Papers on Economic Activity* (Washington, DC: Brookings Institution, Spring), 2011. *www.brookings.edu//media/Files/Programs/ES/BPEA/2011_spring_bpea_papers/2011_spring_bpea_conference_lusardi.pdf*

[7] Annamaria Lusardi, "Americans' Financial Capability", report prepared for the Financial Crisis Inquiry Commission, 2011. *http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0226-Lusardi.pdf*

[8] Debbie Borie-Holtz, Carl Van Horn, and Cliff Zukin, *No End in Sight: The Agony of Prolonged Unemployment,* (New Brunswick, NJ: John J. Heldrich Center for Workforce Develop-

Second, weak balance sheets impact economic growth. Weak balance sheets—especially due to lower household wealth—have had negative "wealth effects" on the economy. Case, Quigley, and Shiller state that "the results indicate that increases in housing market wealth have had positive effects upon household consumption, but declines in housing market wealth have had negative and somewhat larger effects upon consumption." [9] In addition, Mian and Sufi show that "household leverage as of 2006 is a powerful statistical predictor of the severity of the 2007–2009 recession across U.S. counties. Those counties that experienced a large increase in household leverage from 2002 to 2006 showed a sharp relative decline in durable consumption starting in the third quarter of 2006—a full year before the official beginning of the recession in the fourth quarter of 2007." [10] Many others, including the Bank for International Settlements and the International Monetary Fund, have recently identified weak household balance sheets as one of the key factors inhibiting economic growth.

And third, a growing body of evidence indicates that families with assets generally do better in life than those without, and generally experience better social, behavioral, and educational outcomes. Conley, using intergenerational data, showed that "parental education and parental assets are the single best predictor of educational (and other socioeconomic) success for blacks and whites. Parental wealth proves so powerful, in fact, that when added to statistical models, parental income, occupation and race no longer appear to matter. That is, while race, income, job status and net worth all tend to vary hand-in-hand, careful statistical parsing shows that it is really net worth that drives opportunity for the next generation." [11] Moreover, Cooper and Luengo-Prado found that among adults who were in the bottom income quartile from 1984–1989, 34 percent left the bottom by 2003–2005 if their initial savings were low, compared with 55 percent who left the bottom if their initial savings were high—that is, 21 percent more adults moved out of the bottom quartile because they had higher savings. [12] And Butler, Beach, and Winfree found that financial capital, along with family structure and educational attainment, are the three strongest predictors of economic mobility in America. [13]

Further evidence suggests that the earlier in life one has assets, the better that person will do. For example, Cooper and Luengo-Prado found that children of low-saving, low-income parents are significantly less likely to be upwardly mobile than children of high-saving, low-income parents. Specifically, they found that 71 percent of children born to high-saving, low-income parents move up from the bottom income quartile over a generation, compared to only 50 percent of children of low-saving, low-income parents. [14] Elliot and Beverly discovered that, remarkably, youth with any kind of a bank account, as long as the account was in the youth's name, are seven times more likely to attend college than those lacking accounts. [15] Similarly, Zhan and Sherraden found that, after controlling for family income and other parent and child characteristics, financial and nonfinancial assets are positively related to, and unsecured debt is negatively related to, children's college completion. [16]

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ment, Rutgers University, May), 2010. *www.heldrich.rutgers.edu/sites/default/files/content/Work_Trends_May_2010_0.pdf*

[9] Karl E. Case, John M. Quigley, and Robert J. Shiller, "Wealth Effects Revisited 1978–2009", Cowles Foundation Discussion Paper No. 1784 (New Haven, CT: Cowles Foundation for Research in Economics, Yale University, February), 2011. *http://cowles.econ.yale.edu/P/cd/d17b/d1784.pdf*

[10] Mian and Sufi, "Household Leverage and the Recession of 2007–2009".

[11] Dalton Conley, "Savings, Responsibility, and Opportunity in America", Policy Paper (Washington: New America Foundation, April), 2009. *http://newamerica.net/publications/policy/savings_responsibility_and_opportunity_america*

[12] Daniel Cooper and Maria Luengo-Prado, "Savings and Economic Mobility", in Reid Cramer, Rourke O'Brien, Daniel Cooper, and Maria Luengo-Prado, eds., *A Penny Saved Is Mobility Earned: Advancing Economic Mobility Through Savings* (Washington: Pew Charitable Trusts, Economic Mobility Project, November), 2009. *www.economicmobility.org/assets/pdfs/EMP_Savings_Report.pdf*

[13] Stuart M. Butler, William W. Beach, and Paul L. Winfree, *Pathways to Economic Mobility: Key Indicators* (Washington: Pew Charitable Trusts, Economic Mobility Project), 2008. *www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/PEW_EMP_Chartbook_12.pdf*

[14] Cooper and Luengo-Prado, "Savings and Economic Mobility".

[15] William Elliot III and Sondra Beverly, "The Role of Savings and Wealth in Reducing 'Wilt' between Expectations and College Attendance", Research Brief (St. Louis: Center for Social Development, Washington University, January), 2010. *http://csd.wustl.edu/Publications/Documents/RB10-04.pdf*

[16] Min Zhan and Michael Sherraden, "Assets and Liabilities, Race/Ethnicity, and Children's College Education", Research Brief (St. Louis: Center for Social Development, Washington University, February), 2009. *http://csd.wustl.edu/Publications/Documents/RB10-09.pdf*

And Shapiro, combining data analysis and in-person interviews with a demographically wide range of families, found that the presence of even small amounts of wealth at the right times can have a "transformative" effect on the life course.[17]

Policy Ideas for Rebuilding Balance Sheets

For families, reducing their debts and rebuilding their savings—or deleveraging—is already, painfully and slowly, underway. The household savings rate has now reached around 5 percent, which is significantly down from the 9 percent average in the 1980s, on course with the 5 percent average in the 1990s, but well above the nearly zero rates the U.S. fell to in the first part of this century.[18]

Yet millions of families need to delever even more, although, not surprisingly, economists do not agree on ideal or sustainable levels of household savings and debt. Most agree, however, that rebuilding balance sheets and igniting the economy require continuing measures to resolve the housing and foreclosure crisis. Roughly three-quarters of total household debt is mortgage debt, and nearly one-quarter of homeowners nationwide have negative equity.[19] Specific recommendations to resolve the housing crisis are beyond the scope of my expertise and testimony, so I will focus on other ideas to help families build savings and wealth. However, before doing so, I would like to observe that, historically, home ownership has been an effective route to wealth accumulation for generations of families, including for low- and moderate-income families; accordingly, going forward, policy makers and researchers should continue to study responsible paths to home ownership for those who are ready and qualified, with all stakeholders balancing both risks and the rewards.

While several ideas could be offered, let me suggest five savings-based recommendations to rebuild balance sheets that I think hold particular promise.[20] I would like to note that these recommendations are informed by a key insight gleaned from savings experiments in the U.S. and around the world. The most interesting question among researchers is no longer whether low-income families can save, but how they save and what difference it makes. That is, income is not the most important predictor of who saves. Instead, what matters more is who has access to structured savings mechanisms—whether through the workplace, schools, financial institutions, tax returns, community-based organizations, and others. A well-funded asset-building policy, one that includes several billion dollars in tax incentives, is already reaching middle- and upper-income households in the United States,[21] making it easier for them to accumulate savings and wealth; the core policy challenge, then, is to extend those savings mechanisms and incentives to families whose earnings fall below median income.

First, build assets as early in life as possible. As discussed earlier, the evidence thus far suggests that children in homes with assets, or children with assets, do better in life than those lacking assets. Policies that automatically create a savings account at birth for every child born in America, with greater resources available for lower-wealth families, hold promise to expand opportunity and build a stronger middle class over time. Such a policy would, if schools structured financial education classes around the accounts, likely have a significant effect on building financial skills for children and youth—some studies show that financial know-how is the re-

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[17] Thomas M. Shapiro, *The Hidden Cost of Being African American: How Wealth Perpetuates Inequality* (New York: Oxford University Press), 2004.

[18] Bureau of Economic Analysis, *www.bea.gov/newsreleases/national/pi/pinewsrelease.htm;* Federal Reserve Bank of St. Louis, *http://research.stlouisfed.org/fred2/series/PSAVERT;* and Massimo Guidolin and Elizabeth A. La Jeunesse, "The Decline in the U.S. Personal Saving Rate: Is It Real and Is It a Puzzle?" Federal Reserve Bank of St. Louis Review, vol. 89(6), pp. 491–514, 2007.

[19] Board of Governors of the Federal Reserve System, Statistical Release Z.1, "Flow of Funds Accounts of the United States" (September 16), 2011. *www.federalreserve.gov/releases/z1/current/z1.pdf;* and CoreLogic, "New CoreLogic Data Shows Slight Decrease in Negative Equity", news release, June 7, 2011. *www.corelogic.com/about-us/news/new-corelogic-data-shows-slight-decrease-in-negative-equity.aspx*

[20] For this testimony, I will focus on savings-based approaches to building balance sheets, which have many advantages, although I well recognize that other important approaches exist to help low-resource families build assets, including Pell Grants, microenterprise programs, defined-benefit pension programs, various home ownership and rental assistance programs, public safety net programs, and many others.

[21] Butler, Beach, and Winfree, "Pathways to Economic Mobility: Key Indicators"; Reid Cramer and Rachel Black, "The Assets Report 2011: An Assessment of Federal Policies and Proposals To Promote Asset-Building Opportunities" (Washington: New America Foundation, June), 2011.*http://assets.newamerica.net/sites/newamerica.net/files/policydocs/AssetsReport2011.pdf;* and "Corporation for Enterprise Development", "Upside Down: The $400 Billion Federal Asset-Building Budget" (Washington: CFED), 2010. *http://cfed.org/assets/pdfs/UpsideDown_final.pdf*

sult of regular saving, not the source. If such an ambitious policy cannot be achieved in the near term, then I would suggest the creation of a "Kids Roth" or "Roth at Birth" or "Young Savers Account"—a slightly modified Roth Individual Retirement Account (IRA) that, voluntarily, permits children to open and make contributions to a life-long, tax-benefited account that can also be used for post-secondary education and home ownership (as current Roth IRAs allow). The creation of such a nationally sanctioned product directed at kids would likely spur further experimentation around child savings accounts, which has been hampered by product-related challenges over the last several years.

Second, build assets and reduce debts at tax time. Income tax refunds averaged $2,700 in 2008, while about 24 million Earned Income Tax Credit (EITC) recipients received refunds as large as $4,824.[22] These refunds, and the broad reach of the tax system, offer good opportunities to repair or rebuild balance sheets. The IRS's form 8888, which enables all taxpayers to deposit their refunds automatically in up to three separate accounts, holds great promise in leveraging tax refunds into savings and debt reduction. For example, savings bonds, in many ways an ideal product for small savers, can now be purchased directly at tax time. Other interesting pilots, including the "Refund to Savings" Initiative, are under way. To further facilitate savings at tax time, the Savers Credit, which encourages retirement savings among low-income taxpayers, could be improved and made available for contributions to college savings accounts, the purchase of savings bonds, and other preretirement assets. Third, build assets at the workplace. The workplace has always been and remains a fulcrum for building savings and assets. In fact, the vast majority of pension wealth in the U.S. is structured through employers. Experiments, such as those testing "Auto401(k)s" and the "Save More Tomorrow" concept, have generated encouraging results, including for low-income workers, and the Pension Protection Act of 1996 has removed many of the barriers to further expansion of those efforts. To generate more employer-based savings, policy makers could consider proposals to set up automatic payroll deductions into retirement and unrestricted savings accounts outside the workplace, informed by the "AutoIRA" and "AutoSave" concepts currently under discussion. Employers could also encourage direct deposit of paychecks, which appears to lead to better financial inclusion outcomes. Finally, one could also imagine automatic payroll deductions for other assets, such as savings for college or home ownership, with possible incentives to encourage further saving by lower-income workers.

Fourth, build unrestricted savings, which are savings that can be used for emergencies or precautionary purposes and which remain in very high demand by low- and moderate-income consumers.[23] Those with sufficient levels of unrestricted savings are more likely to be banked, more likely to pay down and secure better loans, and more likely to acquire a longer-term asset such as higher education, a small business, or a home. And they do better: The Consumer Federation of America found that low-income families with $500 in emergency savings had better financial outcomes than moderate-income families with lower savings. In addition, McKernan, Ratcliffe, and Vinopal found that households that are "liquid-asset poor" are two to three times more likely than those with liquid assets to experience "material hardship" after a job loss, health emergency, death in the family, or other adverse event.[24] Policy makers could consider several measures to boost unrestricted savings, including (1) expanding the EITC; (2) further studying and testing prepaid cards, which often include a savings "bucket" in addition to transaction services; and (3) promoting reasonably priced small-dollar lending and small-dollar savings programs among financial institutions, nonprofits, and others.

And finally, consider supporting innovations to State-based 529 college savings plans and other ways to generate savings earmarked for college. Many studies have documented the role that a good education, especially completion of a post-secondary degree, has on one's future earning and wealth, and how the lack of an education and skills are among the strongest predictors of downward mobility. Promising innovations to learn from include (1) the "SEED for Oklahoma Kids" experiment, which

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[22] David Newville, "The Saver's Bonus: Encouraging and Facilitating Savings by Families at Tax Time", Policy Paper (Washington: New America Foundation, June), 2009.*www.newamerica.net/files/nafmigration/Savers_Bonus_Two_Pager_FINAL_070209.pdf*

[23] Stephanie Chase, Leah Gjertson, and J. Michael Collins, "Coming Up with Cash in a Pinch: Emergency Savings and Its Alternatives", CFS Issue Brief 6.1 (Madison, WI: Center for Financial Security, University of Wisconsin), 2011. *www.cfs.wisc.edu/Publications-Briefs/Coming_Up_with_Cash_in_a_Pinch_Emergency_Savings_and_Its_Alternatives.pdf*

[24] Signe-Mary McKernan, Caroline Ratcliffe, and Katie Vinopal, "Do Assets Help Families Cope with Adverse Events?" Brief 10 (Washington: The Urban Institute, November), 2009. *www.urban.org/UploadedPDF/411994_help_family_cope.pdf*

is testing 529s established at birth; (2) the "Kindergarten to College" initiative in San Francisco, which is setting up college saving accounts for all of the city's kindergartners; and (3) the "Early Pells" proposal by the College Board, which would enable a Pell-eligible family to receive a child's Pell Grant earlier in life as a deposit to a 529 account.

As implied in the recommendations above, there is a great need to diversify the savings and assets of families, especially those below median income. The wealth of these families has been concentrated in home ownership, which has contributed to the stability and upward mobility of millions of families over time—but which, especially when not acquired responsibly, or because of price fluctuations, ended up being a risky asset for too many families. Home ownership, as mentioned earlier, clearly carries both potential risks and rewards that must be carefully weighed. It is wise, therefore, for families to have access to a range of savings products—short- and longer-term, restricted and unrestricted—that lead to as broad a range of financial assets (such as investments and retirement accounts) and productive assets (such as a home, land, post-secondary education, reliable car, or small business) as possible. As Federal Reserve Board Vice Chair Janet Yellen has said, "In light of this experience [with collapsing housing prices], it makes sense to think about the development of wealth-building vehicles for low- and moderate-income households that have some of the desirable qualities of home ownership as an investment, but perhaps have less of the risk. Such instruments should be simple and transparent and might include a savings commitment component. Although households will likely need to take on some risk in order to accumulate wealth, the risk should not have the potential to destroy a household's financial security. Continued research in this area is badly needed." [25]

Conclusion

Mr. Chairman, I commend you for convening this hearing today to look at high levels of household debt, consumer protection, and rebuilding the middle class. We know that household debt is both weighing down millions of families and stifling economic growth. Thankfully, we have compelling evidence, some of it presented here, suggesting that rebuilding balance sheets and net worth will help hard-hit families and the broader economy move forward. I hope to make a modest contribution to this critical challenge, and I would be pleased to answer any questions that you might have.

PREPARED STATEMENT OF G. MICHAEL FLORES

CHIEF EXECUTIVE OFFICER, BRETTON WOODS, INC.

OCTOBER 4, 2011

Overview

Chairman Brown and Members of the Committee, my name is Michael Flores and I am CEO of Bretton Woods, Inc., an advisory firm in the financial services industry.

My firm is in the initial stages of a new study on the impact to the middle class's access to bank payments and credit facilities. We have completed studies over the last 10 years on overdraft issues as well as the emergence of prepaid cards.

We demonstrated in the early 2000s that the cost of an overdraft was significantly higher that other sources of low dollar, short term credit. We have also shown that the prepaid card issuers with the most significant market share were on a par with basic checking accounts but are now a less expensive option available to the consumer.

Almost every day there is a news release of banks increasing their fees to consumers. At the same time we are hearing that banks have plenty of money to lend but are refraining from doing so.

The results of many studies over the last 10 years, including our own studies, [1] indicate that the majority of overdrafts were incurred by the segment of the consumer base that used free checking. Now that free checking is going away, consumers are closing their checking accounts and, as a result, losing access to this form of short term credit.

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[25] Janet Yellen, "Housing Market Developments and Their Effects on Low- and Moderate-Income Neighborhoods", speech delivered the 2011 Federal Reserve Bank of Cleveland Policy Summit, June 9, 2011.*www.federalreserve.gov/newsevents/speech/yellen20110609a.htm*

[1] *http://bretton-woods.com/71501/index.html*

Our contention is that most banks are operating under a 20th century business model and have yet to adequately devise a 21st century model. Some of the issues involve the net interest margin squeeze banks have endured for the past 15 years as well as recent regulatory changes that have significantly impacted banks' fee income sources. Those primary sources are overdraft fees and interchange fees. Other issues include the quickening pace of technology, the need to meet the expectations of the young consumers while still providing a service model with which the older customers are comfortable.

This is what we refer to as the banks' legacy cost structure of delivering services in an analog world while building the infrastructure for a digital world.

Banks cannot profitably originate and underwrite individual small dollar loans. Our analysis indicates that $1,500 in the break-even point using data from the FDIC Small Dollar Loan Program.

I have included a model in my written testimony for the Committee's review.

Market driven entrants are able to leap frog the old model and build a cost structure to effectively deliver these services at competitive prices. We support the ability of banks and alternative service providers to have the ability to develop strategic partnerships or acquisitions to allow legacy banks be more competitive with entrepreneurial and market driven solutions

A key premise of this hearing is Consumer Protection. I am a true supporter of clear and concise disclosures so the consumer can make an informed decision. However, it is becoming apparent that the law of unintended consequences is alive and well. For example, the reduction in interchange fees to benefit the consumer, which was basically a business to business financial issue between the banks and the merchants, has inadvertently created a significant income redistribution from the consumers to the merchants in the form of higher bank fees to the consumer to lower costs/higher margins for the merchant.

Given this observation, the following are my concerns with the CFPB:

- Concentration of authority with, in my opinion, limited accountability. I believe that the bureau should be accountable to Congress as a check and balance, similar to other agencies.
- I see inherent problems in separating safety and soundness with consumer protection. Limitations on products or pricing beyond market constraints can potentially produce limitations of credit and access to mainstream banking that we are now starting to see. Further reductions in income sources to banks can have a significant impact to safety and soundness.
- Furthermore, the cost of compliance is increasing to a point where many small banks (under $1 billion assets) are limited in their ability to hire the professionals required.
- Finally, I believe the director should report to a board with a broad representation of the interested parties.

Thank you and I look forward to answering your questions.

Supplemental Data

History of Banking Overdraft Fees

In the 1980s, we advised banks to pay all checks from low dollar to high dollar so the bookkeepers would have fewer items to process. Fee income was not the factor it became in the late 1990s. During this time, banks were experiencing interest margin compression, traditional finance companies were exiting the business of offering small dollar, short term credits products (for which the demand did not subside) and technology became available to process checks presented against insufficient funds in an automated process. The result was the development of Courtesy Overdraft Programs that automated the decision process bank bookkeepers and branch managers have manually made for decades.

Given this new technology, banks started offering free checking. The amount of NSF and Overdraft items increased due to the limited options available for short-term/low dollar credit but the costs to handle these items were significantly less. Accounts that banks would not open in the past, they could now do so profitably.

We also changed the presentment order to pay large dollar checks first before the small dollar items. This was established was as a customer service. Paying the mortgage payment or rent or car payment first saved charges and embarrassment of "bouncing" those items. Secondly, when deciding to pay a check into overdraft was limited to checks (before debit cards and ACH became as prominent as they are today), this actually saved the customer money. When a bank returns a check unpaid, it charges the same fee as paying the check into overdraft. The depositing customer typically redeposits that check that may result in another NSF fee plus any merchant fees or late fees or utility reconnect charges. In essence, paying a check into overdraft can be one-third the ultimate cost of returning the check.

When banks extended the Courtesy Overdraft Program to low dollar debit card transactions, the customer ceased to receive value.

The Case for Short-Term Credit Advance Loans

The point with the brief history of overdrafts is that when a customer opens a basic checking account, the bank will still make the pay or return decision on checks presented against insufficient funds (even if the customer "opts-out" of debit card and ATM overdrafts) and charge the fee, regardless of the decision. The result of many studies over the last 10 years, including our own studies,[2] indicates that the majority of NSF/OD charges were incurred by the segment of the consumer base that used free checking.

With the changing landscape of increasing checking account fees, many consumers of free checking are leaving banking for alternatives, including prepaid cards. The fact that some these consumers are out of mainstream banking while others are now paying more for checking accounts does not diminish the demand for low dollar short term credit.

Additionally with several State initiatives and the imposition of Regulation E (opt in requirement) to inhibit access to short term credit, consumers are still in need for this credit facility. The reason banks have started offering deposit advance loans is that individually underwriting small dollar loans is not economically feasible. As a practice, our firm has advised banks since the early 1990s to not originate loans under certain solar limits. The minimum limit found at many banks is now $1,000 for a consumer loan.

Bretton Woods conducted a cost analysis to originate a small dollar loan based on the FDIC Small Dollar Loan Program. Our finding, as indicated in the following chart, show that the minimum loan amount is approximately $1,500 to breakeven.

	FDIC Quarterly Report, Small Dollar Loan Program 2010 Vol 4 No 2							
	Average SDL Loan Amount	Rate	Term	Monthly Payment	Total Payments	Fees	Interest Revenue	Total Revenue
Revenue	$ 724.00	13.09%	12	($64.70)	$776.36	$ 31.00	$52.36	$83.36
	Average SDL Loan Amount	Rate	Term				Interest Expense	Total Interest Expense
Funding Cost	$ 724.00	1.00%	12	($60.66)	$727.93	$ -	$3.93	$3.93
Net Interest Income								$79.43
Other Costs								
Capital Requirement	8.00%							
Return on Equity	12.50%							$3.69
Charge-Offs	$ 724.00	6.20%						$44.89
	Loan Officer *	Underwriter**	Processing***	Servicing****	Pull Through Rate *****			Total Other Costs
Salaries	$ 34.01	$ 25.01	$ 21.18	$ 17.74				$ 97.94
Applications Not Funded					49.25%			$ 49.71
Total Other Costs								$196.23
Net Profit (Loss) Per Loan								($116.80)
	Minimum loan amount to break even							$ 1,529.08

*** Consumer Loan Officer I** $ 56,490.00 median salary plus 25% benefits = $ 34.01 cost per hour.
http://www.bls.gov/oes/current/oes132072.htm Assumes 1 hour per loan at 100% productivity

**** Consumer Loan Underwriter** $ 41,533.00 median salary plus 25% benefits = $ 25.01 cost per hour.
http://www1.salary.com/Consumer-Credit-Analyst-I-Salary.html Assumes 1 hour per loan at 100% productivity

***** Consumer Loan Processor** $ 35,180.00 median salary plus 25% benefits = $ 21.18 cost per hour.
http://www.bls.gov/oes/current/oes_nat.htm#13-0000 Assumes 1 hour per loan at 100% productivity

****** Consumer Loan Servicing** $ 33,390.00 median salary plus 25% benefits = $ 20.10 cost per hour.
http://www1.salary.com/Accounts-Receivable-Clerk-salary.html ($33,390 X 1.25)/2353= $ 17.14

*******Pull through rate**
50.75% of all applications did not result in a closed loan although the time and costs of the loan officer and underwriter are still incurred

Notes:
The 2007 Cornerstone Report = Median 9 consumer loans originated per loan consumer loan officer per month, 93 consumer loans underwritten per loan consumer loan underwriter per month and 145 consumer loan applications processed per comusmer loan processing FTE per month. Use of these benchmarks would
2007 Cornerstone Benchmark Analysis = 2,353 consumer loans serviced per servicing FTE

Interviews with participants of the SDL program indicate that these loans are unprofitable. An excerpt from the FDIC report[3] shows:

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[2] *http://bretton-woods.com/71501/index.html*

[3] *http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf*

- "Nevertheless, as a general guideline, pilot bankers indicated that costs related to launching and marketing small-dollar loan programs and originating and servicing small-dollar loans are similar to other loans. However, given the small size of SDLs and to a lesser extent NSDLs, the interest and fees generated are not always sufficient to achieve robust short-term profitability (emphasis added). Rather, most pilot bankers sought to generate long-term profitability through volume and by using small-dollar loans to cross-sell additional products."

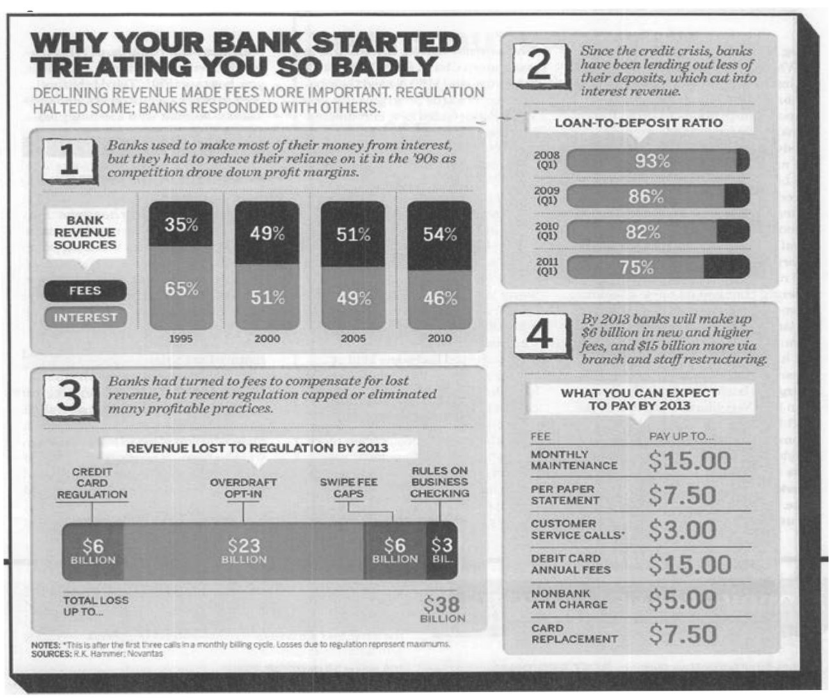
The average loan amount for short term credit is approximately $300 [4] according the Center for Responsible Lending.

Given the average FDIC Small Dollar Loan program loan amount is $724 and our estimate that it takes a minimum $1,500 for a bank to break even on a consumer loan and the demand for a short term loan is $300, *what are the options available to this consumer?*

The market currently has options for unanticipated short-term credit needs in the form of Overdrafts. There are also banks, credit unions and Alternative Financial Services providers that have product for anticipated short term credit needs.

As with all products, features need to be weighed against price. The typical bank or credit union product has a slightly lower price point for a low dollar loan but require the applicant be a customer for a period from 1 month to 4 months and have no other delinquencies with existing credit products. Many consumers who have a need for this credit may not qualify for a checking account because of previous issues and reporting to Chex Systems. Others with existing accounts have or are considering closing their checking account due to higher fees being assessed.

A recent article from *Money Magazine,* "Get a Fair Shake, Not a Shake-down", dated September, 2011, depicts the reasons for this trend in bank fees:



Our own analyses of the cost of checking accounts compared to prepaid cards and check cashing using the Consumers Union standard transaction profile [5] in August of this year shows:

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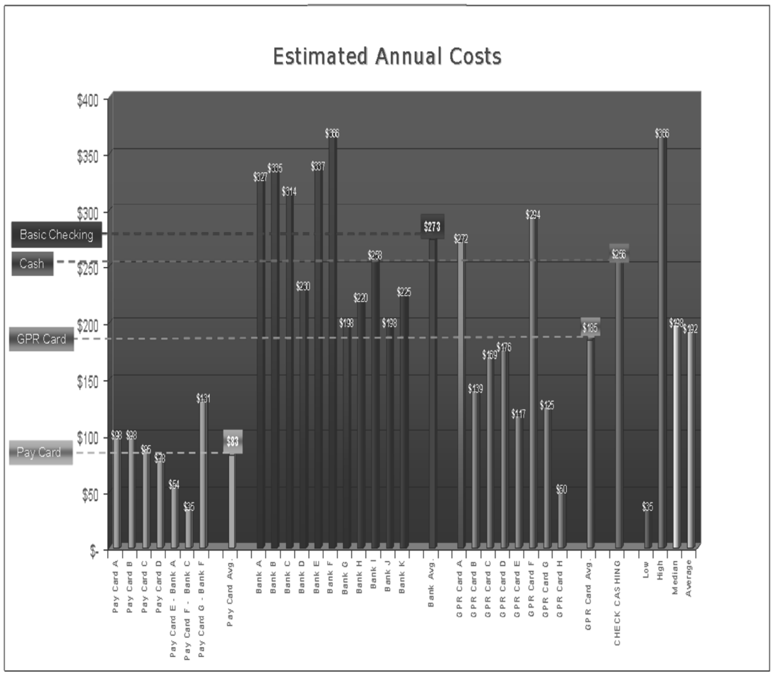
[4] *http://www.responsiblelending.org/payday-lending/research-analysis/payday-loan-inc.pdf*
[5] *http://www.consumersunion.org/pub/core_financial_services/014300.html*



The bank costs are now understated given the recent news from Bank of America and Citibank.

PREPARED STATEMENT OF DOUGLAS FECHER

PRESIDENT AND CHIEF EXECUTIVE OFFICER, WRIGHT-PATTERSON FEDERAL CREDIT UNION, FAIRBORN, OHIO

OCTOBER 4, 2011

Mr. Chairman and Members of the Committee, thank you for the opportunity to speak to you about responsible consumer lending practices.

My name is Doug Fecher, and I am President and CEO of Wright-Patt Credit Union, a $2.1 billion financial cooperative serving more than 210,000 members in Dayton, Ohio, a community hit hard by a challenging economy. In the last 3 years, Dayton has lost thousands of jobs, leaving many of our credit union members to face an uncertain financial future.

Attached to my testimony are several alarming statistics that put the struggles of the typical consumer into perspective.

- A decade ago, the ratio of household debt to disposable income was roughly 80 percent, which, proportionally, allowed people to effectively manage their debt. Today, that ratio is closer to 120 percent, leaving the typical consumer with little safety margin to help them cope in difficult times.
- Consumer savings rates have plummeted. Two decades ago, consumers saved nearly 12 percent of their disposable income; today they save less than 5 percent.
- Home prices have dropped dramatically in the last 5 years, decreasing in value more than 13 percent in 2008 and 5 percent so far this year.

Clearly, the need for affordable financial services has never been greater.

This is precisely where credit unions like Wright-Patt excel. To some, our Nation's credit unions, as not-for-profit, democratically controlled cooperatives—are anachronisms in our modern financial system. But credit unions are different by design with an intensely local focus that has paid enormous dividends during this time of financial crisis and slow economic growth. The numbers speak for themselves:

- Every year of the past four (2007–2010) our Nation's 7,300-plus credit unions have granted over $250 billion in loans;
- Credit union members have over 45 million loans outstanding;
- Credit union loan quality is the strongest of all insured financial institutions, with 60-day delinquency of just 1.6 percent, compared to bank 90-day delinquency of 4.4 percent;
- Credit union net charge-offs peaked in 2009 at 1.22 percent of all loans and are now below 1.0 percent;
- Credit union auto loan market share reached its peak of 22.7 percent when the auto market was at its most difficult point ever during the Great Recession (and in many cases credit unions were the only active lenders in their communities);
- When home prices were failing at the greatest rate, credit unions achieved 5.8 percent market share in mortgage originations, its highest ever; and
- Credit union real estate loan modifications total over $10 billion helping nearly 60,000 members stay in their homes.

Indeed, credit unions in the United States support over 900,000 jobs. We have tripled our mortgage-lending market share in 3 years and become the Nation's #1 manufactured housing lender. And we've restarted a moribund private student market—at affordable rates—so far making more than $1 billion in student loans that have enabled more than 220,000 students advance their education.

And we've done these things by being true to our core values of helping America's consumers make smart money choices with organizations they can trust to help them gain a sense of financial stability in an otherwise difficult environment.

Here's how this plays out at Wright-Patt Credit Union. Our mission is to help folks achieve financial freedom for themselves and their families. Specific to members' use of debt we follow four commonsense principles:

1. Wright-Patt only makes affordable loans members will be able to repay;
2. We tell members exactly what their loans will cost without hidden fees or penalties;
3. We take every opportunity to advise members on how to increase their savings even when they are taking out a loan; and
4. We treat those who fall behind with dignity and respect, and we work closely with members to develop reasonable plans—including modification when appropriate—to return them to sound financial health.

These principles are the foundation of the way we lend. They create an environment where we get to help people change their lives. Here are just a few examples.

Mortgage Modification: Wright-Patt Credit Union makes mortgage loans to help members enjoy affordable long-term home ownership. One member—typical of many—recently found herself in a predatory mortgage loan with a rate and payment she couldn't afford. She was faced with losing her home. Thanks to WPCU's partnership with Miami Valley Fair Housing, she came to Wright-Patt Credit Union. After a lot of hard work by our staff and by the borrower herself, we were able to find a mortgage that lowered her payment and reduced the loan term to 15 years. Had it not been for her credit union, our member would have lost her home through sheriff's sale. Now she gets to keep her house with a payment she can afford and a loan that will help her build equity.

Credit Cards: We also lend for credit cards differently than most. The Nation's largest banks offer credit cards that are designed to get consumers to spend more in the hopes of receiving rewards or cash-back on their purchases. Interest rates on these cards routinely exceed 20 percent. At Wright-Patt, we think credit cards are a convenient payment mechanism, and not a temptation to run up debt. Our credit card does not feature rewards that entice more spending, and we charge a rate starting at just 6.25 percent so members have a reasonable chance of paying their card in full in a manageable period of time.

Emergency "Payday" Loans: Wright-Patt Credit Union also offers a small-dollar loan product called StretchPay so members aren't tempted to visit payday lenders when they run low on cash. StretchPay is now being offered by 51 other credit unions in Ohio, eight other States, and the District of Columbia. StretchPay is a "payday loan alternative," and does three things for members:

1. It offers an emergency line of credit up of $250 at an interest rate of 18 percent and an annual fee of $35. With no new advances until paid in full, we help members avoid a "circle of debt";
2. It improves credit ratings since, unlike payday lenders, we report payments to credit bureaus with the ultimate goal of qualifying members for even lower-cost loans on the strength of a new repayment history; and
3. It helps members start a savings account and provide free financial education to teach them how to build savings rather than use high cost loans to deal with cash emergencies.

First-Time Car Buyers: WPCU serves the airmen and airwomen of Wright-Patterson Air Force Base. Many of these young service men and women come to base straight from high school with little or no financial education. To help them gain reliable transportation without visiting "buy-here, pay-here" lots, we help them locate an affordable car, have it examined by a certified mechanic, and offer a loan rate and payment that fits their financial profile.

Savings Rates: Our credit union's responsibilities to members don't end with lending products. We also incorporate savings programs that encourage members to become financially stronger by building up safety reserves. Every member receives a 5 percent dividend rate on the first $500 they are able to save in their WPCU primary membership account. We use the 5 percent dividend in a time when average rates are less than 0.5 percent as incentive to save. We pay this rate even on accounts with balances as low as $5 so that every member has the opportunity to earn a decent rate on whatever they're able to save.

The Savings Race: Wright-Patt Credit Union, in conjunction with a local television station, plays "The Savings Race" with five local families from October through June. The game plays out on local newscasts and is a contest to see which of the five families is able to improve their net worth the most over the 8 months of the contest. (The game is similar to "The Biggest Loser" on network television which is devoted to losing weight; in our version we improve net worth.) Using WPCU employees as coaches, in 3 years our families have improved their net worth by a combined $389,623 of savings growth and debt reduction—that's an improvement in net worth of more than $25,000 per family. The next season of "The Savings Race—Home Edition" starts October 6.

Financial Education: Financial education is important at Wright-Patt Credit Union. Much of this education is around helping members know how much their loans actually cost and, if we can help them save money, bring their loans to the credit union.

In March, 2011, we challenged members to save at least $50 on high-interest loans by refinancing with Wright-Patt. If we couldn't save at least $50 on their loans, we'd pay them $50. Part of the deal was letting us review their credit report alongside them in detail—an act which opens more than a few eyes to just how much more money folks are spending than they need to. In just 6 months of the credit review program we've helped thousands of members reduce interest payments on existing debt by more than $10 million dollars.

Free Financial Counseling: WPCU provides free budget and debt counseling to members at no cost from their credit union. Our counselors will help negotiate lower payments and settlements so members have a better chance of financial recovery.

Total Savings: In the last 3 years Wright-Patt Credit Union programs have put more than $23 million dollars back in consumers' pockets. Across Ohio, credit unions have put direct financial benefits of $132 million back into the pockets of Ohio's 2.68 million credit union members. Nationwide, credit union members have saved almost $6.5 billion by using credit unions.

We are proud of how much we've helped members save. But, like all smaller financial institutions, we face challenges that hinder our ability to spend time helping consumers.

Since 2008 we've been given more than 160 new rules and regulations from some 27 different Federal agencies. While credit unions would rather hire loan advisors and financial counselors to help consumers improve their financial situation, we're instead hiring compliance offers to deal with the new rules. The largest banks have armies of attorneys to deal with these regulations—we don't. It is not an exaggeration to say our Nation's small, community-based financial institutions are exposed to a situation where they ultimately may be regulated out of business. This should concern us all.

I'd also like to comment briefly on the new Consumer Financial Protection Bureau. Credit unions are generally in support of the bureau's goals; to us, the greater transparency and consumer disclosure required by the new agency simply highlights the way credit unions have always done business. Richard Cordray, a fellow-Ohioan who has been nominated as the agency's director, has outstanding qualifications and understands the unique role credit unions play in the lives of consumers. We hope the agency empowers credit unions to do their jobs of helping consumers make smart use of credit without creating even higher regulatory costs.

Let me close with an email I received just last week from a member who personifies the typical financial conundrum faced by our membership:

> I'm writing you today to inform you of the difference your company has made in my life. My previous car payment was $348 and with my rent being $699 a month including my other household bills I could barely make ends meet. Some weeks I could not feed myself due to the strain of having this enormous car payment. Just two weeks ago your credit union approved me for a car payment of $192. You guys saved me $156 dollars each month. My interest rate went from 23.9 percent down to 8.9 percent. You guys helped me keep food on the table.

This email is one of many I regularly receive, and affirms to me that we are doing what you want us to do—we are taking care of consumers, helping them improve their financial situation, and putting money back in their pockets to use in supporting their families. I believe we need to strengthen America's cooperative credit unions as an essential resource for the current fiscal crisis plaguing this country.

To conclude, I frequently tell my staff that we are not doing our job if our members are not in better financial health today than when they first sought our services. I hope this testimony gives you a glimpse into the benefit we bring to our Nation's financial table.

Thank you for the opportunity to present to you today. I will be glad to answer any questions.

PREPARED STATEMENT OF IDA RADEMACHER

VICE PRESIDENT FOR POLICY AND RESEARCH, CORPORATION FOR ENTERPRISE DEVELOPMENT

OCTOBER 4, 2011

Good afternoon, and a special thank you to the Subcommittee on Consumer Protection and Financial Institutions—especially Chairman Brown and Ranking Member Corker—for convening a hearing focused explicitly on exploring ways to help everyday Americans build (or rebuild) their wealth at a time when our collective and individual balance sheets are very much in the red. For over 30 years my organization has been deeply engaged in researching and advancing promising strategies that help low, moderate and middle income (LMI) families and communities build wealth and financial resiliency. At no time has our work and the work of our many partners been more needed—or more difficult—than right now. And at no time has the leadership of Congress on issues of consumer financial protection and helping families save and build assets been more important than right now.

It is my goal with this testimony to achieve three objectives:

- First, I will provide you with a concise (but bleak) picture of the current state of financial security among middle- and low-income households in America, and describe how the set of policies we currently have on the books to protect LMI consumers and help them build wealth have missed their mark.
- Second, I will present a framework that illustrates—from a household's perspective—what it really takes to build financial security and economic mobility over time.
- Third, I will describe a range of actions that members of Congress—and of this Subcommittee in particular—could take in the near future that would help millions of Americans successfully navigate the financial marketplace and begin to save, invest and build assets that will help us to rebuild our middle class and our economy.

Financial Security and Stability Among LMI Households

The middle-class squeeze in America is more pronounced and more consequential than at any time in modern history. New research in the last few years has really helped us get a better handle on some additional the dimensions of financial security that go beyond income poverty and unemployment statistics. For example:

- Over half of the population in the U.S. with a credit score has what can be considered subprime credit. In some areas, that number closes in on 70 percent.

- One in four Americans either have no bank account, or are considered “underbanked” meaning they use alternative and largely unregulated financial products and services that are often very high cost and abusive. In the African American community, the number of un- and underbanked households rises to one in two, or 50 percent.
- Over half the population doesn’t have enough liquid savings and assets to help them survive at the poverty level for 3 months if they lost their source of income (that’s only about $4,000 for a family of three).
- Another recent survey found that over half the population isn’t confident they could find a way to scrape together $2000K if they had an emergency.
- Last week the company CardHub.com published its Q2 2011 Credit Card Debt Study, showing that consumers accumulated $18.4 billion in new debt in the second quarter of 2011—a 66 percent increase over the same quarter in 2010, and a 368 percent increase over the same period in 2009.
- Middle-income household debt-to-income ratios have risen from 67 percent in 1983 to 100 percent in 2001 and 157 percent in 2007. And the evidence indicates that the debt pile-on was directed at maintaining normal consumption not enhanced consumption.

None of this bodes well for the future of America’s middle class. Make no mistake, “middle income” and “middle class,” are not synonymous. To illustrate this point, consider the 2009 research study from the Pew Economic Mobility Project that found that almost half (45 percent) of black children whose parents were solidly middle income ended up falling into the bottom of the income distribution as adults, compared to only 16 percent of whites.

Clearly there is something besides income that has historically helped to make middle-class status more “sticky” and multigenerational. One of the key “somethings” has been asset development—home ownership, higher education, savings, inheritance—these are all part of the explanation. Historically white families have more of these. A lot more. Professor Thomas Shapiro of Brandeis University and renowned expert on racial wealth disparities finds that white families are four times more likely than blacks to inherit, and when they do the median inheritance is 10 times greater. Another recent Pew report found that between 2005 and 2009 median household wealth plunged 66 percent among Hispanics and 53 percent for blacks, while dropping just 16 percent for white households. The result is that the net worth of white families is now 20 times greater than that of black families and 18 times more than Hispanic households—the largest gap in 25 years. The middle class is shrinking across the board. But for communities of color, the middle is being decimated.

The Role of Tax Policy in Asset Building

The shrinking ranks of the middle class and the growing wealth gap are phenomena that are as predictable as they were preventable. The recession has clearly exacerbated the problem, but at its core the widening wealth gap reflects years of Government policy decisions that disproportionately help high-income households build assets while virtually ignoring the needs of the middle class and explicitly penalizing efforts by low-income households to save and invest.

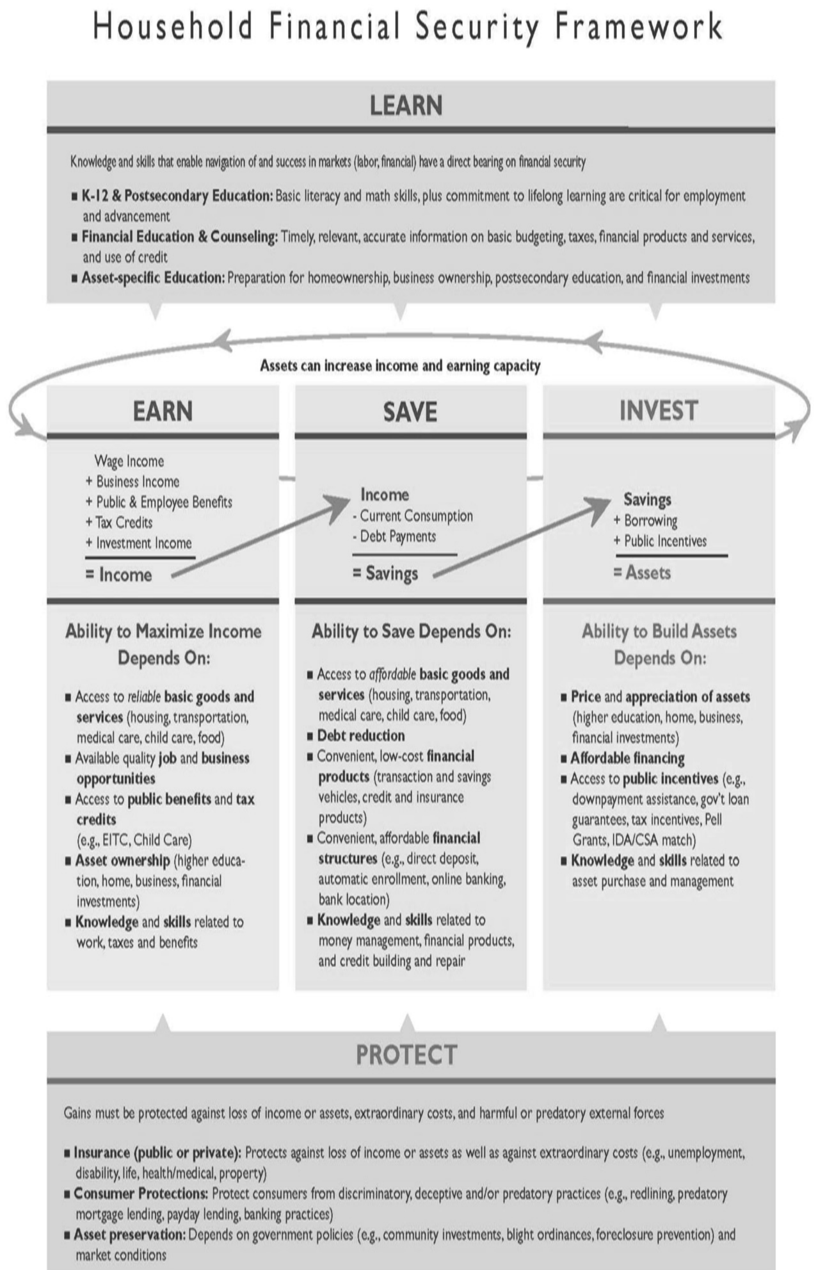
Last year CFED and the Annie E. Casey Foundation published the report “Upside Down”, which showed that the Federal Government spends upwards of $400 billion a year to encourage Americans to save for retirement, go to college, start businesses, and purchase homes. But here’s the catch: These “asset-building” policies are primarily administered through the tax code as special deductions and deferrals. As a result these subsidies are overwhelmingly accessible primarily to Americans in the very highest income brackets, with little evidence that the incentives generate much in the way of net new savings. Meanwhile, the majority of the population in middle- and lower-income brackets who do not have enough of a tax liability to warrant itemizing—those most in need of building a financial cushion to deal with short term income shocks and long term economic uncertainty—receive miniscule levels support.

In 2009 more than half of the $400 billion in asset-building benefits went to the top 5 percent of tax-payers. The bottom 60 percent of households received less than 4 percent of those subsidies. Another cut of the data shows that households making a million dollars or more received a $95,000 subsidy to help them build assets—enough to finance a pretty good college education for their kids. Households making less than $20,000 got about five dollars—enough to finance 2 days of school lunch.

This ineffective and skewed allocation of expensive tax subsidies has added to both the Federal deficit and the growing wealth gap between Americans with means and those working to make ends meet.

A Framework for Household Financial Security

The thing is we do know what it really takes for a household in America to build financial security over time. But at present we don't do a lot to help average families succeed in this endeavor. CFED has created the Household Financial Security Framework to describe the basic elements of building household financial security, which, on the face of it, looks relatively straightforward. Individuals must first learn the knowledge and skills that enable them to earn an income and manage their financial lives. They then use their income to take care of basic living expenses and service debt payments, and then—if income has exceeded expenses—they can save some for future purposes. When they have accumulated enough liquid savings, they can leverage those savings and invest in assets that will appreciate over time and generate increasing levels of income, equity and net worth. Throughout the cycle, access to safe, affordable financial products, insurance and consumer protections help households protect the gains they make.


Household Financial Security Framework
LEARN
Knowledge and skills that enable navigation of and success in markets (labor, financial) have a direct bearing on financial security
K-12 & Postsecondary Education: Basic literacy and math skills, plus commitment to lifelong learning are critical for employment and advancement
Financial Education & Counseling: Timely, relevant, accurate information on basic budgeting, taxes, financial products and services, and use of credit
Asset-specific Education: Preparation for homeownership, business ownership, postsecondary education, and financial investments
Assets can increase income and earning capacity
EARN
Wage Income
+ Business Income
+ Public & Employee Benefits
+ Tax Credits
+ Investment Income
= Income
SAVE
Income
- Current Consumption
- Debt Payments
= Savings
INVEST
Savings
+ Borrowing
+ Public Incentives
= Assets
Ability to Maximize Income Depends On:
Access to reliable basic goods and services (housing, transportation, medical care, child care, food)
Available quality job and business opportunities
Access to public benefits and tax credits (e.g., EITC, Child Care)
Asset ownership (higher education, home, business, financial investments)
Knowledge and skills related to work, taxes and benefits
Ability to Save Depends On:
Access to affordable basic goods and services (housing, transportation, medical care, child care, food)
Debt reduction
Convenient, low-cost financial products (transaction and savings vehicles, credit and insurance products)
Convenient, affordable financial structures (e.g., direct deposit, automatic enrollment, online banking, bank location)
Knowledge and skills related to money management, financial products, and credit building and repair
Ability to Build Assets Depends On:
Price and appreciation of assets (higher education, home, business, financial investments)
Affordable financing
Access to public incentives (e.g., downpayment assistance, gov't loan guarantees, tax incentives, Pell Grants, IDA/CSA match)
Knowledge and skills related to asset purchase and management
PROTECT
Gains must be protected against loss of income or assets, extraordinary costs, and harmful or predatory external forces
Insurance (public or private): Protects against loss of income or assets as well as against extraordinary costs (e.g., unemployment, disability, life, health/medical, property)
Consumer Protections: Protect consumers from discriminatory, deceptive and/or predatory practices (e.g., redlining, predatory mortgage lending, payday lending, banking practices)
Asset preservation: Depends on government policies (e.g., community investments, blight ordinances, foreclosure prevention) and market conditions

In reality, there is nothing particularly straightforward about getting a household balance sheet to balance, much less tip toward asset accumulation. As the data I reviewed earlier makes abundantly clear, financial security is the exception rather than the rule for the majority of Americans. Every day, as people try to navigate the increasingly complex financial marketplace, they need to make choices without full information, clear guidance or adequate protection. It's not that people don't understand the downsides, inconveniences and long-term implications of being unbanked, using costly credit, skipping their mortgage payment or failing to save for college or retirement. But without adequate income, savings or products options, their choices are limited. A big part of the problem has very little to do with individual knowledge and skills and instead has to do with the systems, structures and protections that exist—or don't—in the financial marketplace.

The primary goal of policy change aimed at strengthening the financial security of households should be to ensure that the market provides a range of safe, affordable, and accessible financial products that meet the transactional, savings and credit needs of low- and moderate-income households and to establish consumer protections that enable all households to participate fully in the consumer financial markets with confidence and trust.

Which brings me to my final objective: Outlining a range of specific policies and actions I would urge Members of the Subcommittee to take with your colleagues to improve the asset building opportunities of all Americans.

Federal Policies To Encourage Asset Building and Consumer Protection

Some would argue that in the current economic climate, with so many people struggling just to make ends meet, it isn't realistic to focus on saving and wealth building. But this view is unnecessarily limited; earning and saving is not an either/or scenario, and it is incumbent on us to help households find a way to do both. Saving is critical for low-, moderate- and middle-income households precisely because these families are the most vulnerable to income shocks from job loss, medical emergencies, and even car repairs. Such emergencies can knock them totally off course financially. Research from the Urban Institute shows that owning a small amount of assets—even just the $4,000 or so that it takes to move out of asset poverty—provides as much protection against material hardship in the face of an economic shock as being in the next highest tier of the income distribution. As a starting point, we must at the very least commit to getting people on the path toward financial stability by giving them the tools and assistance required to reduce debt, repair credit, get banked and build savings, and by protecting them from scams and from abusive and deceptive products. Households need access to safe, affordable consumer financial products and services. Individuals and families need to have information in order to effectively compare the costs and benefits of different financial products and make the best choices for themselves.

CFPB Recommendations

A significant portion of this work now falls under the purview of the Consumer Financial Protection Bureau. This institution can provide vital support to consumers in the financial markets, and do so without massive new Government spending or onerous mandates. Rather, CFPB can do a great deal to facilitate savings and asset building by LMI households through ensuring that consumers' interests are considered and valued in the context of Federal financial regulation processes that already exist. Congress, of course, has a critical role to fulfill with regard to CFPB; you can ensure that the Bureau is fully capable of meeting its mission and establish accountability for achieving its goals.

- *The first step that the Senate should take is to confirm a director to lead CFPB.* One of the overarching goals of the Dodd-Frank Act was to unify the oversight and regulation of the entire financial services marketplace under one set of clear, transparent rules with consumer well-being in mind. Without a director, the Consumer Financial Protection Bureau doesn't have the authority to regulate many types of nonbank financial businesses, leading to an uneven playing field in which some firms are required to play by the rules while others are not. The Bureau is significantly restricted in its ability to regulate in many areas, including nonbank financial institutions, payday lenders, private education lenders, consumer credit rating agencies, and mortgage servicers.

  CFPB must have a confirmed director not just for administrative reasons or to expand its authority, but also to actually achieve its primary objective: to protect consumers from financial products that exacerbate financial distress. Rather than banning "bad" products, the Bureau's leadership has indicated that it plans to pursue this mission through incenting the delivery of products and services that provide measurable benefits to consumers and by ensuring the consumers have the information they need to make informed choices about what products and services are best for them. The alternative credit industry thrives for three reasons all too familiar to consumer protection experts: first, the intense demand for emergency credit; second, a captive, vulnerable, and often unsophisticated population; and third, the lack of a single, clear, trustworthy, and enforceable regulations for the product landscape. CFED commends the Bureau for its intention to focus on improving consumers' ability to access and understand information about these credit products through disclosures, financial education, and supervision of lenders.

- *Congress should encourage the CFPB to focus on improving disclosures for all consumer financial products.* Both transaction products and credit products can and often do build hidden fees and penalties into their products that create conditions of financial uncertainty for LMI consumers that they can ill-afford. With transaction products, issues include overdraft charges, insufficient funds fees or point of sale charges. For example, research by former Assistant Secretary of the Treasury Michael Barr shows that the most important features of transaction products for LMI consumers are transparent monthly costs and Federal consumer protection.
- *The CFPB should examine the impact that expanding the amount of information reported to consumer credit rating agencies would have in helping thin- and no-file consumers build their credit records.* The CFPB should study and supervise the credit information markets with an eye toward increasing their transparency and fairness.

  Consumer credit reports are now sought not just by prospective lenders evaluating specific consumers' loan applications, but also by landlords, employers, banks and others. Credit reports have never been more critical to a person's ability to participate in the financial mainstream, but they are opaque, lightly regulated, and difficult for consumers to work with. Moreover, as many as 70 million Americans have no credit files or no payment histories in their credit files, and consequently have no credit score. Tens of millions more have too few payment histories in their credit files to be scored with precision. A straightforward solution is to simply add more information to credit files. Utility and telecommunications bills are nearly universal; including all payment information for these transactions would enhance credit access for millions of households. This market-driven policy response will help lenders better assess credit applicants and decrease the Nation's persistent—and widening—wealth gap.

Congress, however, has an important role here, that the Bureau alone cannot accomplish. Despite compelling evidence that alternative data credit reporting is a win-win scenario for borrowers and lenders, utility and telecom firms are reluctant to report full payment histories to the credit bureaus due to regulatory uncertainty; currently most firms only report late payments. Some States have introduced legislation to promote alternative data credit reporting while others have moved to prohibit the practice. At the Federal level, some companies that previously reported full payment histories to the credit bureaus have stopped due to uncertainty about privacy requirements. Congress can resolve the uncertainty through legislation that provides affirmative permission to utilities and telecom firms to report all payment history to the consumer credit bureaus.

Beyond the CFPB

Looking beyond the CFPB, Congress can support many equally important policy reforms and new opportunities to enhance the ability of LMI families to save money and build assets. Our research shows that current U.S. policies—or at least the 90 percent that operate as tax expenditures—are regressive, invisible and unregulated. They are of little help to the majority of households that are trying and become more financially secure. Significant improvements could be made with the following proposals:

Remove Disincentives To Save

One way to do this would be to eliminate asset tests as this would primarily benefit working poor households. Asset limits, or caps on the maximum value of assets a household may have to be eligible for certain benefits programs, deter people from seeking work, opening bank accounts and saving money. CFED supports reforms that encourage economic self-reliance. Congress should consider removing the penalties in our safety net programs for developing savings that can eventually help families become financially independent. Congress could follow the lead of Ohio, Virginia, Alabama, Louisiana, and Maryland—all States that have eliminated asset tests in their TANF program. They realized that families applying for TANF had no real financial assets. The cost of staff time to find nonexistent assets was exorbitant—Virginia reported that it was spending about $330,000 a year to weed out just one-half-of-one percent of participants. We commend Congress for making progress: Senator Chambliss led efforts to exempt IRAs, 529 and Coverdells from asset limit tests in SNAP. But further action is needed.

Congress should raise asset limits in SSI. The current rates, set at $2,000 in the 1980s and never raised for inflation, dampen initiative and discouraged people from banking and saving, working toward some amount of financial self reliance. The Senate could follow the lead of the bipartisan SSI Saver's Act (H.R. 2103).

Improve the Existing System for Savings

Expand the Saver's Credit. The Saver's Credit should be strengthened and reformed to enable millions of Americans to receive an additional incentive to build their savings and enhance their financial security. The original Saver's Credit passed in 2001. The IRS recently released data showing that 6.4 million tax filers claimed the credit in 2009, the largest number of claimants ever. The average credit was only $167 though, largely because tax filers with income low enough to claim the credit have limited tax liabilities. This speaks to the need to improve the credit, so it can serve the purpose it was designed for: make saving for retirement rewarding and straightforward for low- and moderate-income workers. CFED proposes expanding the Saver's Credit to provide a 50 percent match on retirement savings up to $500 ($1,000 for joint filers), making the credit refundable, and depositing the match directly into the filer's retirement savings account. With these changes, the Saver's Credit would reach as many as 50 million tax filers. This would provide powerful incentive to lower-income people who desperately need to build wealth and provide an easy, safe way for them to save and invest.

Enact Automatic IRA. Seventy-eight million people, half of the U.S. workforce, lack access to employer-sponsored retirement plans. Automatic IRA is a legislation that will enable workers without a retirement plan at work to use payroll deductions to open and fund IRAs with a minimum of effort. Increasing personal retirement savings is a critical challenge that policy makers should address. Social Security has been the most effective solution to elderly poverty, but it will be increasingly important for workers to supplement Social Security with personal savings. Automatic IRA is an inexpensive, market-friendly way to ensure that 78 million workers have the opportunity to save.

Reauthorize the Assets for Independence Act. The Senate should reauthorize and improve the Assets for Independence Act (AFIA, P.L. 105-285). Individual Development Accounts (IDAs) are a proven tool to help low-income families achieve financial security through savings and asset building, and AFIA is the primary source of Federal support for IDAs. The Assets for Independence program is one of the few programs that reaches low-income households that focuses on wealth-building and financial education to help these households get ahead. As a result, AFIA has been critical to the success and widespread adoption of IDAs from few accounts in the 1990s to more than 120,000 accounts today.

Unfortunately, current economic realities such as State budget crises and reduced availability of philanthropic grants pose challenges to a program that has successfully helped low-income families lift themselves out of poverty. Strong interest and limited local funds have resulted in nearly every IDA program in the country placing potential savers on waiting lists. The reauthorization of AFIA presents an important opportunity to make small, but critical modifications to increase AFIA's utilization and ensure its continued success. Recommendations include improving and streamlining requirements and opportunities for grantees, expanding participant eligibility qualifications and savings goals, and developing new partnerships, promoting research, and encouraging innovation.

Build a New System of Child Savings Accounts

Children's savings accounts (CSAs), tax-preferred investment accounts opened for each child at birth, are powerful financial products that could expand economic and educational opportunities for children by encouraging long-term planning, building family wealth and promoting financial literacy. CFED supports the efforts of our colleagues at the New America Foundation to establish a lifetime savings account for every newborn child in America. The America Saving for Personal Investment, Retirement, and Education Act (The ASPIRE Act) would set up a special account at birth for every child that could later be used to pursue post-secondary education, buy a first home, or build up a nest egg for retirement. The ASPIRE Act calls for each child's LSA to be endowed with a one-time $500 contribution at birth. Children living in households with incomes below national median income will be eligible for both a supplemental contribution of up to $500 at birth as well as the opportunity to earn up to $500 per year in matching funds for amounts saved in the account. Financial education would be offered in conjunction with the accounts." [1]

States and cities are starting to recognize the value and potential of offering children's savings accounts. In Maine, every child is eligible for $500 in a college savings 529 account, and 12 other States now match contributions to 529s. In San Francisco, every public Kindergarten student is given a savings account upon enrollment that is seeded with $50 ($100 if they receive free and reduced cost lunch), and provided with matching incentives and financial education over time. Singapore, Canada, and even the United Kingdom have used state funds to open bank accounts for kids realizing that kids with college funds are more likely to achieve financially.

Taken together, all of these policy proposals would cost a small fraction of what the Federal Government currently spends to subsidize asset building for taxpayers in the highest income brackets, and could easily be funded by capping some of those expensive unfair and ineffective subsidies currently in place. Most importantly, they would begin to address some of the long-term inequities that contribute to the wealth gap, and they would help millions of families build a more secure economic future.

Mr. Chairman, thank you very much for this opportunity to testify before the Subcommittee. I would be pleased to answer any questions you and the other Members of the Subcommittee may have.

PREPARED STATEMENT OF SUSAN K. WEINSTOCK

DIRECTOR, SAFE CHECKING PROJECT, PEW HEALTH GROUP, THE PEW CHARITABLE TRUSTS

OCTOBER 4, 2011

Thank you Chairman Brown, Ranking Member Corker, and Members of the Subcommittee for the opportunity to submit testimony about the importance of transparent and fair financial products and services as a means to sustain and build wealth. The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and stimulate civic life. Based on research and critical analysis, the Pew Health Group seeks to improve the health and well-being of all Americans. One important component of which is consumer financial product safety, as research by the Federal Reserve has documented the link between socioeconomic status and health. [1]

Pew's Safe Checking in the Electronic Age Project aims to restore transparency, fairness, responsibility and free market principles to one of the most common consumer financial products—the checking account. We appreciate this opportunity to provide further details on our consumer financial products and services research. Our findings demonstrate the importance of consumer financial protections, which allow families to manage their money responsibly and build savings and assets. Based on our research, Pew developed policy recommendations that would bring needed transparency, fairness, and free market principles to checking accounts.

Nine out of 10 Americans have a checking account, making it the most widely utilized financial services product. These accounts provide a secure way for Americans to collect earnings and make payments, and for many, they serve as the entry to the financial mainstream, where savings and credit products are available. As vehicles for millions of transactions each day, checking accounts are essential to the national economy.

In October 2010, the Pew Health Group's Safe Checking in the Electronic Age Project began a study of checking account terms and conditions to examine both the state of the marketplace and the effect of current regulations covering checking accounts. [2] We analyzed more than 250 types of checking accounts offered online by the 10 largest banks in the United States, which held nearly 60 percent of deposit volume nationwide. Through this research, we identified a number of practices that put consumers at financial risk, potentially exposing them to high costs for little benefit. I would like to highlight three of these concerns: (1) the need for a disclosure box laying out account terms, conditions, and fees; (2) complete disclosure of

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[1] *http://assets.newamerica.net/the__aspire__act*

[1] Daly, Mary, Greg Duncan, Peggy McDonough, and David Williams, "Optimal Indicators of Socioeconomic Status for Health Research", *American Journal of Public Health*, 2002 Jul; 92(7): 1151–1157. *http://www.ncbi.nlm.nih.gov/pubmed/12084700*

[2] Pew Health Group, "Hidden Risks: The Case for Safe and Transparent Checking Accounts", April 2011. *http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Safe__Checking__in__the__Electronic__Age/Pew__Report__HiddenRisks.pdf*

all overdraft options; and (3) prohibition of transaction reordering that maximizes overdraft fees.

Clear Disclosure Makes the Market More Efficient by Allowing Comparison Shopping

Consumers need a clear, concise, and easy-to-understand disclosure of their checking account terms and conditions.

Disclosures are critical for consumers to make informed decisions, but the information needs to be presented in a format that is clear and understandable. They should convey key terms and conditions with clarity so that consumers can compare products and make purchasing decisions that best meet their needs. Clear disclosures will foster a transparent, fair, and competitive marketplace for all financial institutions by allowing them to compete for customers on a more level playing field.

Unfortunately, the checking accounts in our study did not meet this standard. We found a median of 111 pages of disclosure documents, consisting of account agreements, addenda to account agreements, fee schedules, and pages on the bank's Web site. The banks often used different names for the same fee or service; put the information in different documents, different media (Web or hard copy), or different locations in a document; and did not summarize or collect key information anywhere. Many of these documents are not user-friendly, with much of the text densely printed, difficult to decipher, and highly technical and legalistic. In response, we have developed a model disclosure box that could be used by financial institutions to provide relevant information to checking account customers (see below).

Pew's Model Disclosure Box for Checking Accounts

BASIC TERMS AND CONDITIONS				
Account Opening and Usage		Minimum Deposit Needed to Open Account	$	
		Monthly Fee	$	
		Requirements to Waive Monthly Fee		*Minimum combined account balance, direct deposit or other conditions*
		Interest Rate	%	
		ATM Fees	$	**for using your bank's ATM**
		ATM Fees	$	**for using another bank's ATM**
		Non-Sufficient Funds (NSF) Fee	$	**per item**
		Returned Check Fee	$	**per declined check written to your account**
		Stop Payment Fee	$	**per item to stop payment for up to X months**
		Account Closing Fee	$	**if account closed within Y days of opening**
		Other Service Fees		**Please consult the back of this document for a list of additional service fees.**
Overdraft Options for Consumers with Debit Cards	Option A: (Default)	No Overdraft Service		**If you choose not to opt in to any kind of overdraft service, transactions that would cause an overdraft will be declined at no cost to you.**
	Option B:	Overdraft Transfer Fee	$	**per overdraft covered by transfer from linked savings account, line of credit or credit card**
	Option C: Overdraft Penalty	Overdraft Penalty Fee	$	**per overdraft covered by bank advance**
		Maximum Number of Overdraft Penalty Fees per Day		
		Extended Overdraft Penalty Fee	$	**every Mth day the account is overdrawn, starting N days after the account is first overdrawn**
Processing Policies		Posting Order *The order in which withdrawals and deposits are processed*		*Summary of policy*
		Deposit Hold Policy *When funds deposited to your account are available*		**• Cash deposit with teller: X business day • Cash deposit at ATM: X business day • Check deposit with teller: Y business day • Check deposit at ATM: Y business day • Direct deposit: X business day • Wire transfer: X business day • If something causes a longer hold on a deposit, the first $200 of that deposit will be made available either the same business day of the deposit or the next business day. • Funds from non-bank checks may take an extra business day to become available.** *A "business day" is a non-holiday weekday. The end of a business day varies by branch, but it is no earlier than T p.m.*
Dispute Resolution		Dispute Resolution Agreement		*Summary of agreement*

In developing the disclosure box, we tested different versions with consumers. In Philadelphia, Minneapolis, and Los Angeles, we heard from two groups of consumers who had opened a checking account within the past 2 years: one with parents who had assisted a young adult child and one with adults ages 21 to 35. Across all groups, participants were quite positive about the disclosure box. They described the information in the box as "comprehensive" and "clear," and felt that a concise, easy-to-understand disclosure document would be useful and valuable when opening a checking account. Across groups, the box was seen as providing information that might help individuals avoid fees, penalties, and personal financial errors. One participant said, "It's knowledge first of what you are doing so you don't mess your account up." Many thought the disclosure box would be useful if they wanted to investigate a bank and/or compare banks on the basis of fees.

As a follow-up, in July 2011, Pew commissioned a national survey of U.S. checking account holders. We found that 78 percent of account holders find that requiring banks to provide a one-page summary of information about checking accounts' terms, conditions, and fees would be a positive change, while only 4 percent say this would be a negative change. Eight-six percent of Democrats, 74 percent of those who identify as independents, 73 percent of Republicans, and 69 percent of those who identify with the Tea Party say this would be a positive change.

The Truth in Savings Act (TISA) requires banks to offer a schedule of specified terms and conditions for all deposit accounts prior to account opening. Such disclosures must be available on demand to consumers so that they can "understand and compare accounts." Similarly, the Electronic Fund Transfer Act (EFTA) requires financial institutions to disclose the terms and conditions when a consumer enrolls in electronic fund transfer services, such as an ATM or debit card.

Under the Dodd-Frank Act, the rulemaking authority of TISA and EFTA passed over to the Consumer Financial Protection Bureau (CFPB) on July 21, 2011. The CFPB has the authority and should require a one-page form that would provide account holders with important fees and terms. This regulatory change would strengthen disclosure requirements so customers are given all important information about their accounts up front and would enable them to shop around for the products most suitable to their needs.

All Overdraft Options and Their Costs Should Be Disclosed

Consumers should receive comprehensive information about all available overdraft options including fee amount.

Currently, there are two main categories of overdraft products. Because banks use different terms for these products, Pew defines "overdraft penalty plans" as short-term advances made for a fee by the bank to cover an overdraft, the median cost of which is $35. "Overdraft transfer plans" involve a transfer from another account or plan—a savings account, credit card, or overdraft line of credit—with a median cost of $10. The vast majority of accounts provided by the banks in our study offered both types of overdraft plans.

As of August 15, 2010, new Federal Reserve rules require that financial institutions obtain customers' affirmative consent (known as opt-in) before enrolling them in an overdraft penalty plan that covers debit card transactions at points-of-sale and ATMs. If a customer does not opt-in, any debit card transactions that overdraw the account will be denied with no fee charged.

Although Pew supports this rule, we would have preferred the Federal Reserve include a requirement that comprehensive information about all available overdraft options (including fee amount) be provided when the account holder seeks overdraft coverage. Now that these rules have transferred to the CFPB, we believe that it should amend the Federal Reserve's rules to ensure that overdraft policy disclosures are clear and comprehensive. Consumers need to understand that they have three overdraft options and what each costs: not opting in, which is free; overdraft transfer plans, and overdraft penalty plans. They should require full disclosure of consumers' overdraft options prior to opt-in and as part of the disclosure box. We would like to see the CFPB issue a model form that would achieve more effective disclosure of overdraft options.

In Pew's focus groups we learned that of those participants who were familiar with overdraft options, some were generally well-informed about banking. However, several others had learned about overdraft options "the hard way," when they or their child had overdrawn an account and accrued one or more fees. Participants also expressed concern that banks depict overdraft policies as "protection" and as a benefit. They tended to see overdraft protection instead as a way for banks to collect a fee, usually multiple fees.

Our July survey showed support for better disclosure of overdraft options, with 83 percent of account holders saying they wanted banks to be required to provide a summary of information about the overdraft options they offer, how the options work and a description of the fees, while only 2 percent said this would be a negative change. Ninety percent of Democrats, 78 percent of those who identify as independents, 81 percent of Republicans and 79 percent of those who identify with the Tea Party said this would be a positive change, while only 1 percent of Democrats, 2 percent of independents, 2 percent of Republicans and 2 percent of Tea Partiers said this would be a negative change. Eighty-two percent of those who said they have a very good understanding of the terms, conditions, and fees associated with their checking account indicated this would be a positive change, while only 2 percent said this would be a negative change.

Transaction Reordering Maximizes Overdraft Fees

Policy makers should require depository institutions to post deposits and withdrawals in a fully disclosed, objective, and neutral manner that does not maximize overdraft fees, such as chronological order.

Transactions (debits, deposits, and checks) presented on a given day for posting are frequently processed in an order different from that in which the activity occurred. Such reordering can greatly impact the overdraft fees incurred by consumers. Our research shows that as of October 2010, only one of the 10 banks studied, representing less than 5 percent of accounts, informed account holders of the order in which all debits and credits are posted.

Yet at the time of the study, all banks and all accounts reserved the right to process debits presented in a given day from highest dollar amount to lowest dollar amount. By reordering transactions to pay the largest items first, the money in a checking account is more quickly depleted so that if a customer overdrafts each small transaction will result in a fee. Since that time, some banks have begun disclosing changes to their practices. Wells Fargo, Chase, and Citibank announced that they would no longer reorder certain types of transactions for at least a portion of their accounts.

Currently, there are no Federal regulations that govern the order of posting among transactions processed on the same day. There is no legal requirement that banks post deposits before withdrawals, nor any law or regulation governing the order in which they post debits or credits. The Federal Deposit Insurance Corporation's overdraft guidance issued in November, 2010, states that its member banks should review their checking procedures to "ensure they operate in a manner that avoids maximizing customer overdrafts and related fees through the clearing order." The Office of the Comptroller of the Currency (OCC) released a draft guidance for comment in June also inquiring about this practice.

In addition, posting orders that maximize overdraft fees, especially those that post withdrawals from largest to smallest, continue to be the subject of court challenges as an unfair and deceptive practice under State law. A Federal judge in California ruled against Wells Fargo on this practice and stated in his summary of the case, "[T]he essence of this case is that Wells Fargo has devised a bookkeeping device to turn what would ordinarily be one overdraft into as many as 10 overdrafts, thereby dramatically multiplying the number of fees the bank can extract from a single mistake." [3]

Opponents of this practice say it enriches the bank at the expense of consumers who receive no benefit from the reordering of their daily debits or credits. In response, banks have contended that customers prefer the largest withdrawals to be posted first because these are the most important (such as rent or mortgage payments), and therefore are the transactions that one wants to have paid first. However, by opting in to overdraft coverage, the customer has expressed the desire to have all overdrafts covered, regardless of size.

We maintain that policy makers should require depository institutions to post deposits and withdrawals in a fully disclosed, objective, and neutral manner that does not maximize overdraft fees, such as chronological order. Our July survey shows that the majority of the checking account holders agree. Seventy percent of respondents said it would be a positive change to require banks to process transactions in the order in which they occur, as opposed to processing them from highest dollar amount to lowest dollar amount, which can lead to more overdraft fees.

Hidden Bank Fees Can Drive Consumers Out of the Banking System

To encourage the working poor to build savings and credit, banks, community organizations, local leaders, and policy makers can promote policies that allow households to use their bank accounts effectively and beneficially.

[3] *Gutierrez v. Wells Fargo Bank, N.A.,* 730 F. Supp. 2d 1080, 1082 (N.D. Cal. 2010).

This month, Pew will release a longitudinal study of 2,000 low-income Los Angeles area households, 1,000 with and 1,000 without a bank account, which explores the connections between financial services, the populations they serve or are failing to serve, and the financial stability of those populations. We found, not surprisingly, that between 2009 and 2010, a time of great economic turmoil throughout the country, the ranks of the unbanked (those without a bank account) increased, with more families leaving banking than opening bank accounts. But what was surprising was that the most common reason these households cited for leaving banking was unexpected or unexplained fees. Nearly one in three listed these fees as the reason for leaving banking. This is particularly relevant given that even in difficult economic times only 27 percent attributed their departure from banking to job loss or lack of funds.

Our study also found that banks hold significant service and location advantages over alternative financial service (AFS) providers: 79 percent of crossover respondents (those with at least one bank account that regularly use AFS) report that banks have better customer service than check cashers and 59 percent prefer the location of banks to that of check cashers. However, these customers continue to supplement their depository accounts with services from AFS providers, citing the need to access cash quickly (30 percent) and the ability to purchase multiple services, such as money orders and remittances, at one time (38 percent).

Finally, we found that the banked could better sustain their savings behaviors, including those associated with long-term goals such as paying for college, even during economic turmoil and when faced with high rates of job loss and declining household income.

To encourage the working poor to build savings and credit, banks, community organizations, local leaders, and policy makers can promote policies that allow households to use their bank accounts effectively and beneficially. Additionally, the continued use of AFS by banked households presents an opportunity for banks to utilize their competitive advantage and capture this market for revenue-generating financial services. For example, banks can provide a comprehensive suite of products including money orders, remittances, check-cashing, bill pay services, and personal loans. Community organizations, local governments, depository institutions, along with efforts to reach the unbanked, such as the Bank On programs, can provide financial education to help new customers manage costs and build up assets. Banks, policy makers, and community organizations can capitalize on household aspirations to build family financial security by providing low-cost, easy-to-understand opportunities for savings and asset building.

Pew's research demonstrates that bank policies and practices have a central role in allowing consumers to use and manage their money responsibly. Yet unexpected fees continue to plague consumers. For vulnerable populations, these fees can mean the difference between having a checking account and forgoing these services altogether. Providing information in a clear, concise disclosure box so that consumers can comparison shop for an account that best meets their needs will enhance competition and make the market more efficient. Practices that maximize fees, like transaction reordering, should be prohibited, since this makes it very difficult for consumers to manage their money and avoid these charges. Transactions should be processed in a predictable manner that responsible consumers can follow. Posting order should be objective and neutral rather than designed to maximize fees. These changes allow consumers to build and sustain wealth by removing much of the hidden risks currently found in checking accounts.

Thank you.