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Committee on Financial Services
Committee on Small Business

Hearing on
Condition of Small Business and Commercial Real Estate Lending
in Local Markets

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Professor Zywicki is a member of the Board of Directors of the Bill of Rights Institute, the Governing Board and the Advisory Council for the Financial Services Research Program at George Washington University School of Business, the Executive Committee for the Federalist Society's Financial Institutions and E-Commerce Practice Group, the Advisory Council of the Competitive Enterprise Institute, and the Program Advisory Board of the Foundation for Research on Economics and the Environment. He is currently the Chair of the Academic Advisory Council for the following organizations: The Bill of Rights Institute, the film "We the People in IMAX," and the McCormick-Tribune Foundation "Freedom Museum" in Chicago, Illinois. He serves on the Board of Directors of the Bill of Rights Institute. Since 2009 he has been a member of the Board of Trustees of Yorktown University. From 2005-2009 he served as an elected Alumni Trustee of the Dartmouth College Board of Trustees.

It is my pleasure to testify today on the subject of the “Condition of Small Business and Commercial Real Estate Lending in Local Markets.” Other members of this panel will address this question with respect to the economic and financial practicalities of lending at the local level. I will address my remarks to the negative impact of recently-enacted and contemplated future legislation in interfering with a well-functioning lending market and in creating an environment of uncertainty that discourages lending.

It is well-known that many independent entrepreneurial businesses rely on consumer credit in starting and building their businesses, such as credit cards, home equity loans, and even auto title loans. As a result, regulations ostensibly aimed at consumer lending will also tend to disrupt small business lending as well. Thus, in my testimony, while I will usually refer to consumer lending, it should be understood that my remarks apply to many small businesses as well.

Prudent and well-designed governmental regulation of consumer and small business lending can in some instances promote competition, consumer choice, and overall productive lending. For example, a statute like the original Truth-in-Lending Act—at least as it was originally conceived and designed and before it became encrusted with mounds of regulation and litigation—can expand consumer choice and improve the operation of the lending market by standardizing and simplifying disclosures so that borrowers can compare among competing offers.¹

But lending regulations may have a large number of unintended consequences as well—and most relevant to this hearing, one of those unintended consequences is the

¹ See Thomas A. Durkin & Gregory Elliehausen, *Truth in Lending: Theory, History and a Way Forward* (Forthcoming 2010, Oxford University Press).

curtailment of lending, especially to small, entrepreneurial businesses. Unintended consequences are most likely and most severe when of legislation and regulation goes beyond the modest goals of improving the market process but instead supplants individual choice through the substantive regulation of particular terms of credit contracts.

In order to make an economically prudent loan, a bank has two considerations. First, it must be able to estimate the risk of the loan and price the loan effectively. Regulations that either increase the risk of lending or make it more difficult to accurately price risk will make this more difficult and expensive. Second, if it is unable to accurately price the loan accurately, it will have to reduce its risk exposure, either by limiting those to whom it will lend (to only the lowest risk borrowers) or by reducing the amount it lends (by reducing the size of the loans made or the credit lines on credit cards).

Provisions in recent legislation, such as the Credit CARD Act, has made it more difficult for credit card issuers to price risk efficiently. The consequences have been predictable: credit card issuers have tried to adjust other terms of credit card agreements in order to try to continue pricing risk efficiently and to the extent that they have been unable to do so they have acted to reduce their risk exposure by offering fewer loans and reducing borrowers' credit lines. If enacted, proposed legislation such as a proposed national interest rate ceiling on credit cards, the proposed Consumer Financial Protection Agency, and the proposal to permit cramdown of home mortgages, would further exacerbate this credit crunch by further increasing the risk of lending.

The Credit CARD Act

Last summer Congress enacted the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the “Credit CARD Act”). Some of the terms of the legislation were relatively minor (such as rules governing the timing of the receipt of bill payments) or imposed relatively minor costs with modest potential offsetting benefits. On the other hand, other provisions of the law interfered with accurate risk-based pricing, such as new limitations on interest rate adjustments and default provisions.

The market response to the CARD Act illustrates how regulation can disrupt lending markets by interfering with efficient risk-based pricing. Credit cards have multiple terms including (as a small sample) interest rates, penalty interest rates, annual fees, length of grace periods, the amount and circumstances under which behavior-based fees will be assessed, degree of acceptance by merchants, fixed versus annual interest rates, customer support responsiveness, rewards, cash-back, frequent flyer miles, affinity terms, additional benefits like car rental and purchase price protection, international transaction fees, fraud protection, effective liability for theft, cash-advance fees, telephone payment fees, and probably many others.

The CARD Act placed political limitations on the ability of lenders and borrowers to establish these terms through free market processes. In order to try to price risk accurately and offset declining revenues from newly-regulated card terms, card issuers have re-priced other terms of credit card agreements. As a result, borrowers have seen new or increased annual fees, fixed-interest rate cards have been converted to variable-rate cards, frequent flyer and other rewards cards have become stingier, and other fees (such as cash-advance fees) have risen.

Most notably, some provisions of the Credit CARD Act make it more difficult for card issuers to raise rates on consumers as economic circumstances change except in connection with the expiration of an introductory period. Again, the market response has been entirely predictable: Credit card issuers have raised interest rates on *all* cardholders in order to guard against the risk that they might need to raise rates later but might be unable to do so as the result of regulation. In some instances, card issuers have responded by increasing their use of cards with low introductory rates but higher permanent rates. It is not clear why this particular mix of terms should be encouraged by regulators rather than lower interest rates for all.

More relevant for the subject of this hearing, there have been widespread reports that as a result of the CARD Act credit card issuers have slashed credit line and canceled credit cards. Although this reflects several different factors, in part this reflects the negative effect of the CARD Act, which has interfered with the ability of card issuers to price risk effectively. Where it becomes more difficult to price risk accurately, lenders will respond by reducing their risk exposure—which, in this case means reducing credit lines and the number of people who can obtain cards. Many of those who have seen their credit lines reduced or cards canceled have reportedly been forced to turn to payday lenders or pawnshops to make up the difference.

National Usury Ceiling on Credit Cards

Several news reports have highlighted a new subprime credit card with a 79% APR.² According to news stories, the card issuer says that the card used to have higher up-front fees but a much lower APR of 9.9%, an arrangement that was prohibited by the

² *Mandatory Usury in One Lesson*, WALL ST. J. p. A10 (Jan. 2, 2010).

Credit CARD Act. It is not obvious that consumers have been made better off by the switch—and if they preferred the card with a 79 percent interest rate and lower up-front fees, presumably a card issuer would have been happy to offer it to them.

Perhaps partially in response to the announcement of this card, there are reports that certain members of Congress have proposed legislation that would institute a national interest rate ceiling of sixteen percent on credit cards. Such a move would almost certainly generate a return of high annual fees, higher behavior-based fees, more pressure to sell ancillary products (such as credit insurance), and a decline in card quality (such as fraud protection and card benefits). It is little wonder that for centuries usury regulations have received the near-universal condemnation of economists.

The most thoroughly studied recent episode was that of the disruptive impact of state usury regulations during the high-interest rate period of the 1970s and early 1980s that limited consumer interest rates below the rate that would prevail in a free market.³

Banks responded by altering other terms of the cardholder agreement or bundling lending with other services. Banks in states with strict usury regulations restricted their hours of operation, reduced customer service, tied their lending operations to other products and services not restricted in price (such as requiring checking or savings accounts), or imposing higher service charges on demand deposit accounts or checking account overdrafts.⁴ Most importantly, to evade usury regulations credit card issuers

³ Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79, 151-55 (2000).

⁴ A. CHARLENE SULLIVAN, EVIDENCE OF THE EFFECT OF RESTRICTIVE LOAN RATE CEILINGS ON PRICES OF FINANCIAL SERVICES (Credit Research Center Working Paper No 36, 1980); *see also* RICHARD PETERSON & GREGORY A. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE 33 (Credit Research Center Working Paper No. 40, 1981).

imposed annual fees on credit cards, usually ranging from \$30-\$50.⁵ Credit card issuers adjusted other terms of the credit contract to compensate for the inability to charge a market rate of interest, including adjusting grace periods and using alternate methods for calculating interest charges.⁶ Credit card issuers also rationed credit card privileges to only the most credit worthy consumers.⁷ Economists have noted that the welfare effect of term re-pricing is almost invariably negative, because if the borrower and lender had preferred the new mix of terms to the old mix, in a competitive market they would likely have done so already.⁸

But there was a still more important type of term re-pricing at work that affected most consumers. For consumers, bank-type credit cards are generally superior to credit cards offered by particular department stores because unlike a store card a bank card unhooks the consumer's choice of payment from the seller of the goods or services, thereby encouraging heightened competition and consumer choice in both realms

Thus, during this period of strict interest rate regulation store cards remained the predominant form of consumer credit, not because they were superior in quality to bank cards but rather because department stores were able to engage in term re-pricing more efficaciously than bank cards.⁹ While banks tried to offset losses on interest rates by imposing annual fees and the like, credit-issuing department stores had an even more

⁵ See Zywicki, *Economics of Credit Cards*, *supra* note 3, at 152. Because this fee was assessed on revolvers and transactors alike, it effectively resulted in transactors subsidizing lower interest rates for revolvers.

⁶ DAVID EVANS & RICHARD SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 28 (1st ed. 2000); MARTHA L. OLNEY, *BUY NOW, PAY LATER: ADVERTISING, CREDIT, AND CONSUMER DURABLES IN THE 1920S* at 132 (1991) ("State usury laws were ineffective; lenders managed to increase effective rates of interest through various fees, penalties, required insurance, and so on.").

⁷ Glenn B. Canner & James T. Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 73 FED. RES. BULL. 1, 2 (1987).

⁸ Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 238 (1986).

⁹ PETERSON & FALLS, *supra* note 4.

effective way of evading usury restrictions—they could simply hide the credit losses by charging a higher price for the goods they offered.¹⁰ For instance, in those states with the strictest usury restrictions, consumers also paid significantly higher prices for major appliances, almost all of which then (as now) were purchased with installment retail credit.¹¹ Retailers in states with strict usury regulations also reduced their services to consumers, such as charging for delivery and gift wrapping or offering fewer choices in their stores.¹² This ability to cross-subsidize between credit and goods transactions provided large retailers with a substantial comparative advantage over smaller retailers who could not afford to establish and maintain their own credit operations.¹³

Finally, to the extent that it becomes too difficult to price the terms of the loan accurately to make the loan feasible, lenders will curtail their issuance of credit cards. For example, if the presence of a regulation makes it impossible for a borrower to gain access to credit card credit, in many situations the borrower will turn instead to a less-preferred type of credit, such as payday lending, rent-to-own, or pawn shops. Again, empirical evidence supports this finding. During the 1970s, states with lower interest rate ceilings (thus foreclosing more consumers from credit cards and other preferred types of

¹⁰ See SIDNEY HOMER & RICHARD SYLLA, A HISTORY OF INTEREST RATES 428 (3d ed. 1991); see also LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 177 (1999) (noting practice of door-to-door peddlers in early-twentieth century America who catered to immigrant families and marked up the price of the goods sold to cover implied high interest rates). Similarly, pawn shops can simply adjust the discount price of the goods that are pawned as collateral.

¹¹ Canner & Fergus, *supra* note 7, at 11.

¹² Peterson & Falls, *supra* note 4, at 35 n.5.

¹³ Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 238 (1986).

lending) had more pawn shops than in states with less-binding constraints.¹⁴ Some borrowers may even be forced to resort to illegal loan sharks.¹⁵

Recent experience with the turmoil in credit markets—even prior to the imposition of new regulations that would shrink lending still further—has provided a timely reminder of how restricting access to preferred types of consumer credit can lead to product substitution. According to news reports, reduction in the availability of credit card credit has led consumers and small businesses to increase their use of inferior and archaic types of credit such as payday lenders, pawn shops, and layaway. Further regulations that would make more highly-preferred credit (such as credit cards) still more uneconomical will likely prompt still further greater use of these alternative types of credit.

CFPA

The proposal for a Consumer Financial Protection Agency is probably the most dangerous of the various proposals being contemplated in terms of its likely disruptive effect on lending markets. This is because of its vast reach potentially touching almost every consumer credit transaction, its vaguely defined mission and charter, and its disconnect of consumer protection from issues of safety and soundness. With a massive new, virtually unconstrained and unaccountable bureaucracy like the CFPA, it would become extremely difficult for lenders to predict the associated with a loan, especially to small entrepreneurial businesses and less-proven borrowers. It would also potentially

¹⁴ RICHARD L. PETERSON & GREGORY A. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE (Credit Research Ctr. Working Paper No. 40, 1981).

¹⁵ See POLICIS, THE EFFECT OF INTEREST RATE CONTROLS IN OTHER COUNTRIES (2004); POLICIS, ECONOMIC AND SOCIAL RISKS OF CONSUMER CREDIT MARKET REGULATION (2006).

increase the costs of lending operations by increasing the red tape and administrative costs of lending. Finally, by disconnecting consumer protection from safety and soundness regulation it would interfere with the ability of lenders to price risk efficiently and thereby lead them to further curtail lending operations.

First, the CFPA would impose the potential for major new liability on lenders. While the details remain up in the air, it appears that it is being contemplated to empower such an agency to impose new fines and penalties. Moreover, in addition to prohibiting lenders from engaging in fraud and deception in lending, the CFPA would have the power to prohibit and punish “abusive” lending—a wholly novel and undefined term. Presumably this term could apply to any loan with higher than average costs or any other term that the regulator might subsequently deem to be “abusive” in some subjective sense. This would cast a cloud of uncertainty over all but the most generic loans made to the safest of borrowers, a certain recipe for further constriction of lending.

Second, the CFPA holds the potential for increased administrative and red tape costs for lenders. Again, it is not exactly clear how such an agency would work. But it is doubtful that any such agency would *reduce* the administrative costs of lending. Again, to the extent that the agency requires a higher degree of paperwork or other hurdles for all but generic loans, this will likely deter lending. Some commentators in the media, for example, have contended that the CFPA would have the power to ban or regulate certain fees on credit cards not covered by the Credit CARD Act or would be able to place limits on the power of lenders to cancel credit cards or reduce credit lines.

Finally, by disconnecting consumer protection from safety and soundness, the CFPA could make it more difficult to price risk accurately, thereby leading to a further

constriction of credit. Consider just two areas identified by the White House as possible areas of action by the CFPB: a proposal to ban (or strongly discourage) prepayment penalties and banning “yield spread premiums” in mortgage products. Both of these actions would likely prove counterproductive and harmful to consumers.

Prepayment penalties are a common term in many subprime mortgages, although they remain uncommon in most prime mortgages in the United States. Prepayment penalties are also included in most commercial loans and are present in virtually all European mortgages. Yet the White Paper contemplates banning prepayment penalties in mortgages. This reasoning is based on faulty economic logic and fails to recognize the overwhelming economic evidence supporting the efficiency of prepayment penalties.

The traditional American right to prepay and refinance a mortgage is relatively unique in the world. Available empirical evidence indicates that American consumers pay a substantial premium for this unlimited prepayment right. Borrowers pay a premium for the unlimited right to prepay of approximately 20 to 50 basis points (.2 to .5 percentage points) with subprime borrowers generally paying a higher premium for the right to prepay than prime borrowers because of the increased risk of subprime borrower prepayment.¹⁶ Borrowers pay this premium to compensate lenders for the risk of having to reinvest funds at lower market interest rates when interest rate falls. Where prepayment penalties are banned lenders also take other precautions to guard against the risk of

¹⁶ See Todd J. Zywicki and Joseph Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 18-20 (2009) (summarizing studies); Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages*, 60 J. ECON. & BUS. 33, 34 (2008) (reviewing studies); Chris Mayer, Tomasz Piskorski & Alexei Tchisty, *The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers* (Apr. 28, 2008). Term sheets offered to mortgage brokers similarly quoted interest-rate increases of approximately 50 basis points in those states that prohibited prepayment penalties.

prepayment, such as charging increased points or upfront fees at the time of the loan, which raise the initial cost of the loan.

Nor is there any evidence that prepayment penalties are excessively risky for consumers. Empirical evidence indicates that prepayment penalties do not increase the risk of borrower default. In fact, subprime loans that contain prepayment penalty clauses are less likely to default than those without such clauses, perhaps because of the lower interest rate on loans with prepayment penalties or perhaps because the acceptance of a prepayment penalty provides a valuable and accurate signal of the borrower's intentions.¹⁷ Acceptance by a borrower of a prepayment penalty may also provide a credible signal by the borrower of his intent not to prepay the loan, thus overcoming an adverse selection in the marketplace and permitting a reduction in interest rates. Borrowers obviously have greater knowledge than lenders about the relative likelihood that the borrower will prepay the mortgage, especially in the subprime market where prepayment tends to be highly idiosyncratic and borrower-specific.¹⁸

Finally, the ability of American consumers to freely prepay and refinance their mortgages may have exacerbated the current mortgage crisis—and banning prepayment penalties might thus exacerbate a similar situation in the future. When home prices were rising, many consumers refinanced their mortgages to withdraw equity from their homes. These “cash-out” refinancings became increasingly common during the duration of the housing boom—from 2003 to 2006 the percentage of refinances that involved cash-out

¹⁷ Christopher Mayer, Tomasz Piskorski, and Alexei Tchisty, *The Inefficiency of Refinancing: Why Prepayment Penalties are Good for Risky Borrowers*, Working Paper (Apr. 28, 2008); Sherlund also finds that the presence of prepayment penalties does not raise the propensity for default. Sherlund, *The Past, Present, and Future*.

¹⁸ See Zywicki & Adamson, *supra*.

rose doubled from under 40 percent to over 80 percent¹⁹ and among subprime refinanced loans in the 2006-2007 period around 90 percent involved some cash out²⁰. In fact, even though there was a documented rise in LTV ratios between 2003-2007, even that may underestimate the true increase in the LTV ratio if appraisals for refinance purposes were inflated (either intentionally or unintentionally), as appraisals are a less-accurate measure of value than actual sales.²¹ The ability to freely prepay and refinance one's mortgage may help to explain the higher propensity for American consumers to default than in comparably-situated countries where prepayment is more difficult and thus cash-out refinancings are not as common.

This suggests that a ban or limitation on contractual agreements for prepayment penalties would encourage even more refinancing activity and further equity depletion that would otherwise be the case—thereby having the unintended consequence of *increasing* the number of foreclosures.

New restrictions on mortgage brokers would also likely be counterproductive for consumers. First, it should be noted that the fixation on the “yield-spread premium” for mortgage brokers is obviously misplaced: this is nothing more than the difference between the wholesale and retail cost of funds. Every loan from a depository lender also has an implicit yield-spread premium embedded in it.

More fundamentally, the White Paper's apparent hostility to mortgage brokers fundamentally misunderstands the nature of competition and consumer choice in this

¹⁹ Luci Ellis, *The Housing Meltdown: Why Did it Happen in the United States*, BANK FOR INTERNATIONAL SETTLEMENTS BIS WORKING PAPER 259 at 22 and Fig. 9 (Sept. 2008), available in <http://www.bis.org/publ/work259.pdf>.

²⁰ C J Mayer & Karen Pence, *Subprime Mortgages: What, Where, and To Whom*, NBER Working Paper no. 14083.

²¹ Ellis, *The Housing Meltdown*, at 22; Chris Mayer, Karen Pence, and Shane M. Sherlund, *The Rise in Mortgage Defaults* at 6.

market. New regulations that might result in a reduction in the number of mortgage brokers, and thus an attenuation of competition, will likely result in harm to consumers. Both economic theory and empirical evidence in this area strongly suggest that greater competition among mortgage brokers results in better loan terms for consumers.

Mortgage brokers are confronted with two distinct incentives. First, mortgage brokers have an incentive to maximize the “spread” between the rate at which they can acquire funds to lend to consumers (essentially the wholesale rate) and the rate at which they can lend to borrowers (the retail price). But second, mortgage brokers face competition from other brokers trying to get a borrower to borrow from them. The net result of these two factors—one pushing toward higher rates and one pushing toward lower rates—is ambiguous as an *a priori* matter.

Early studies have found various different results, some finding that brokers offer better terms on average than depository lenders and others finding that brokers charge higher prices on at least some elements of the transaction.²² The explanation for these differing results appears to result from differences in the number of mortgage brokers competing in a given market.²³ Where mortgage brokers are numerous and thus competition and consumer choice is greater, consumers generally receive lower interest rates from brokers (the competition effect predominates); but where there are a smaller number of brokers and less competition, consumers typically pay higher interest rates

²² Compare Amany El Anshasy, Gregory Elliehausen & Yoshiaki Shimazaki, *The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders* (July 2005) (working paper, available at http://www.chicagofed.org/cedric/files/2005.conf_paper_session1_elliehausen.pdf); see also Gregory Elliehausen, *The Pricing of Subprime Mortgages at Mortgage Brokers and Lenders* (Feb. 2008) (working paper) (updated results confirming the initial findings) with WOODWARD, *supra* note 143, at ix (concluding that loans made by mortgage brokers have higher costs of \$300 to \$425).

²³ M. Cary Collins & Keith D. Harvey, *Mortgage Brokers and Mortgage Rate Spreads: Their Pricing Influence Depends on Neighborhood Type*, J. REAL ESTATE FIN. & ECON. (Forthcoming 2009).

(the broker interest effect predominates). Empirical studies indicate that overly-restrictive broker regulations may also lead to a higher number of foreclosures overall.²⁴ The lesson seems to be clear—regulators should be wary of adopting overly-stringent regulations that will substantially reduce the number of mortgage brokers in a given market. Similar findings characterize many industries where overly-stringent regulations result in higher prices and other welfare losses for consumers.

Cramdown of Home Mortgages

Another proposal that would increase the risk of lending and lead to further constriction of credit would be the proposal to allow cramdown of home mortgages in bankruptcy. That this would increase the risk of home mortgage lending is obvious. Less obvious, but no less important, is that this would increase the risk of other types of lending such as credit cards and auto loans.

Cramdown in bankruptcy differs from mortgage modification outside bankruptcy in that if a consumer files bankruptcy in order to cram down his mortgage, the impact is not limited merely to the mortgage debt. Bankruptcy sweeps in all other types of debt as well, including credit cards, auto loans, and personal finance loans. By permitting mortgages to be modified in bankruptcy instead of foreclosure, permitting cramdown of mortgages in bankruptcy would certainly lead to an increase in the number of people filing bankruptcy. This would, of course, increase the amount of other types of consumer debt pulled into—and eventually discharged—in bankruptcy. More generally, any proposal that led to an overall increase in the number of bankruptcy filings inevitably

²⁴ Morris M. Kleiner & Richard M. Todd, *Mortgage Broker Regulations That Matter: Analyzing Earnings, Employment, and Outcomes for Consumers* (working paper Nov. 2008).

would lead to an increase in the amount of consumer debt discharged in bankruptcy and an increase in risk.