Testimony of Mark A. Calabria, Ph.D.
Director, Financial Regulation Studies, Cato Institute
Before the
U.S. House Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs

On "Credit Crunch: Is the CFPB Restricting Consumer Access to Credit?"
July 24, 2012

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Chairman McHenry, Ranking Member Quigley, and distinguished members of the Subcommittees, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

First I would like to commend the Chairman's effort to bring oversight to the Consumer Financial Protection Bureau (CFPB), which last week marked its first year in operation. Given the unusual structure of the CFPB, one that I believe reduces transparency and accountability, and the questionable manner in which its current leadership was put into place, diligent and constant Congressional oversight is badly needed.

Had Congress fulfilled its responsibilities in previous years in regards to such entities as Fannie Mae and Freddie Mac, we might have avoided the recent financial crisis. As the CFPB runs the same risk of politicizing our consumer credits markets in a manner similar to which our mortgage market was so highly politicized, I believe aggressive Congressional oversight is needed in order to both avoid future financial crises and to maintain a healthy economy.

Credit Market Conditions

In order to assess the impact of the CFPB on consumer credit, we must first look to the overall conditions in our credit markets. Last week the Federal Reserve presented its Monetary Report to the Congress[1]. The Federal Reserve observed that (page 15):

> "Consumer credit expanded at an annual rate of about 6¼ percent in the first five months of 2012, driven by an increase in nonrevolving credit. This component accounts for about two-thirds of total consumer credit and primarily consists of auto and student loans. The rise in nonrevolving credit so far this year was primarily due to the strength in student loans, which were almost entirely originated and funded by the federal government. Meanwhile, auto loans maintained a steady pace of increase. Revolving consumer credit (primarily credit card lending) remained much more subdued in the first five months of the year in part because nonprime borrowers continued to face tight underwriting standards. Overall, the increase in consumer credit is consistent with recent responses to the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) indicating that demand had strengthened and standards had eased, on net, for all consumer loan categories.
>
> Interest rates on consumer loans generally edged down in the first half of 2012, and spreads on these loans relative to Treasury securities of comparable maturity held fairly steady. In particular, interest rates on new auto loans continued to be quite low. However, the spread of rates on credit card loans relative to the two-year Treasury yield has remained wide since the end of 2008 in part because of pricing adjustments made in response to provisions included in the Credit Card Accountability Responsibility and Disclosure Act of 2009."

In plain English, the Federal Reserve is stating that other than student loans, which are almost completely now backed by the government, and auto loans, our credit markets remain constrained. To its credit, the Federal Reserve notes that the Card Act of 2009 has significantly increased the interest spread for credit card loans. Responsibility for the Card Act has shifted to the CFPB.

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[1] http://www.federalreserve.gov/monetarypolicy/files/20120717_mprfullreport.pdf

Mortgage Market Conditions

A particular focus of my experience has been in the area of federal mortgage finance. As housing remains one of the largest drags on the economy and is particularly sensitive to credit conditions, I will place the emphasis of my testimony on the CFPB's activities in this area, particularly as it relates to the CPFB's rule-making activities under the HOEPA, RESPA and TILA.

The problem facing our housing market is a combination of weak demand and excess supply. One of the constraints on housing demand is mortgage availability. If one is a prime borrower, who can make a substantial down-payment, then mortgages are both cheap and plentiful. If one is not, then a mortgage is difficult, if not impossible to get.

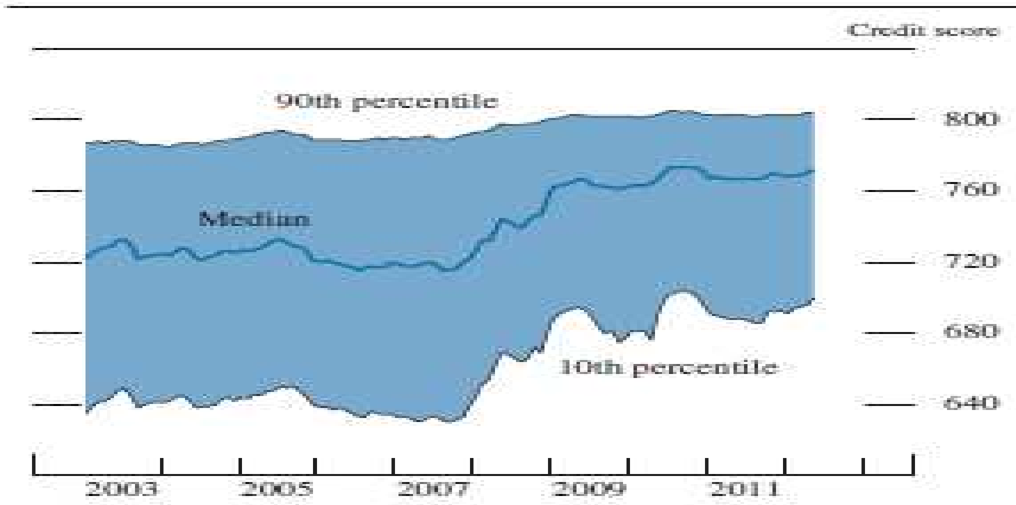
Again to quote from the Federal Reserve Monetary Report to Congress (page 18):

> "Access to mortgage credit is among the important factors that affect the demand for housing and thus the recovery in the housing sector. Lending standards appear to be considerably tighter than they were even before the housing boom, likely preventing many households from purchasing homes.
>
> According to the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), from mid-2007 into 2009, many lenders tightened their standards for residential mortgages originated to borrowers with prime credit scores, and very few have eased standards since then. Moreover, the market for nontraditional mortgages continues to be impaired, while the market for subprime mortgages remains effectively closed. Similarly, the range of credit scores on newly originated prime mortgages has remained elevated since lenders shifted toward higher-rated borrowers in 2008. The upward shift in credit scores is also evident for prime borrowers who refinanced their mortgages and for Federal Housing Administration mortgages."

This decline in mortgage availability derives from a variety of factors, some good, and some bad. For instance the most irresponsible lending, with the exception of FHA, is gone, at least for the moment. That is a good thing. As the Federal Reserve, however, has noted, mortgage lending standards are tighter than that witnessed *pre-boom*, indicating that we are not simply

seeing a correction in reaction to the boom, but a restriction in credit beyond what would be expected. As noted, much of the Alt-A and higher quality subprime lending is also gone. That is not such a good thing. By my estimate about a fifth of the mortgage market has disappeared, holding back housing demand.

B. Credit scores on new prime mortgages, 2003–12



NOTE: Includes purchase mortgages only. The data are monthly and extend through May 2012.
SOURCE: LPS Applied Analytics.

The reduction in mortgage availability is illustrated by the dramatic increase in median credit scores on new prime loans, which have increased from just under 720 in 2007 to almost 770 today. Most of his increase has been driven by an increase in the bottom of the credit score distribution. Recall that this considers prime loans only. Of course there are substantial differences in default probabilities within prime. Lenders appear to be reducing credit to those borrowers within prime that are most likely to default, and hence most likely to invoke various “consumer protections” in order to avoid foreclosure. These are the loans which would entail the largest regulatory and litigation costs, so it is not surprisingly that lenders have reacted to these increased costs by limiting credit to borrowers most prone to litigation and regulatory enforcement. Reductions in subprime and Alt-A credit have been even more dramatic.

One of the factors contributing to that disappearance is the combination of Federal Reserve interest rate policy with federal mortgage regulation.

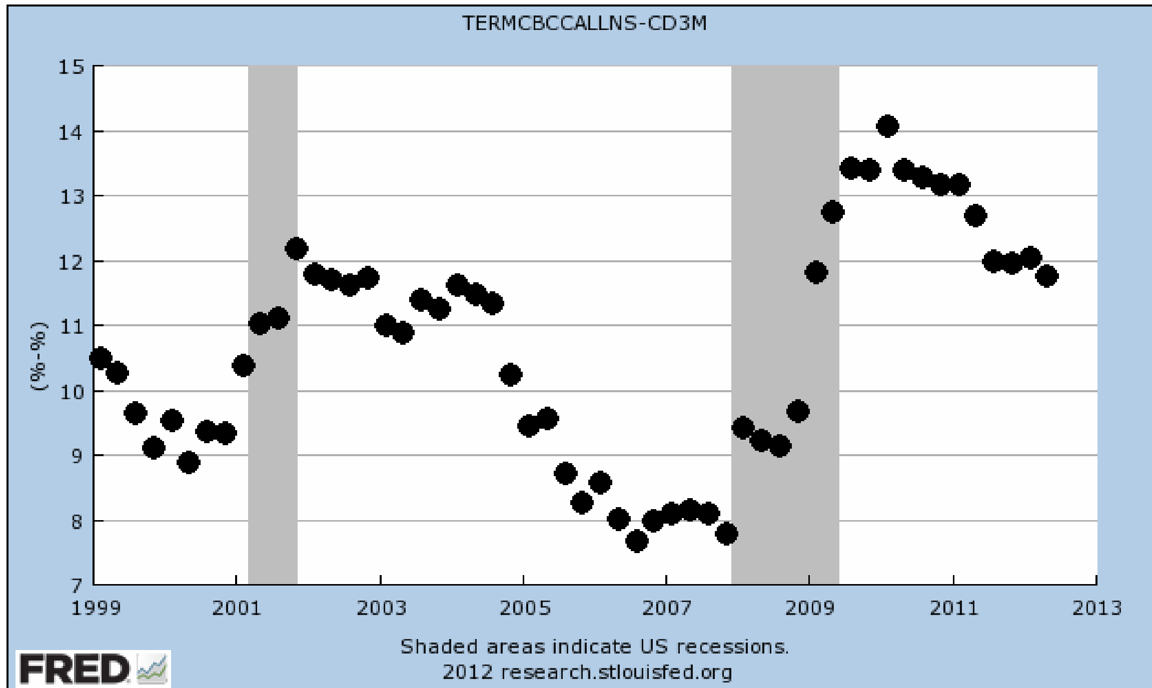
Under HOEPA, whose administration has transferred from the Federal Reserve to the CFPB, any mortgage over 5.5 percent is considered "high-cost" in the current interest rate environment. Such mortgages now carry considerable regulatory, reputation and litigation risk. Historically speaking, 5.5 percent is a great rate, not a predatory one. Charts, at the end of this testimony, display the distribution of mortgages rates charged in 2006 and 2011. It should be immediately clear that 2006 largely resembled a normal distribution. 2011, however, has seen the right side of that distribution largely eliminated. Clearly the distribution of mortgage rates in 2011 is nowhere near normal or symmetric.

While one should always keep in mind that economics does not offer one the luxury of a natural experiment, we do not get to hold everything constant, I believe the expansion of consumer finance regulation since the financial crisis has increased the cost of consumer credit while decreasing its availability.

Credit Crunch and Monetary Policy

This expansion has also reduced the effectiveness of monetary policy. While the Federal Reserve can lower its target policy rate, its ability to impact the economy is limited by the willingness of lenders to extend credit. One area that appears to be adversely impacted has been in the area of credit cards. Despite a five percentage point decline in the federal funds rate since 2007, the interest rate on credit card accounts have only fallen by a little more than 1 percentage point. As the credit card market is fairly competitive and rates can adjust relatively quickly to cover interest rate risk, the increased spread of credit card rates over other benchmarks suggests increased credit and legal risk. The largest declines in credit card lending did not occur during the depths of the financial crisis or the recession but after the implementation of the Card Act.

The following chart displays the spread between credit card rates and 3 month certificate of deposit rates, which controls for a bank’s cost of funds. As the chart clearly illustrates, the spread of credit card rates over cost of funds dramatically increased following the implementation of the Card Act. While this spread would be expected in increase in a recessionary environment, the increased was considerably greater than witnessed in previous recessions and the subsequent decline was been relatively lower.



Macroeconomic Impacts of Credit Crunch

Interestingly enough economists Josh Wright at George Mason University and David Evans at the University of Chicago predicted in late 2010 that the CFPB would raise the cost of consumer credit by on average 160 basis points[2]. Examining the spread of various forms of consumer credit over the Treasury rate, it would appear that if anything their estimate was too conservative. As an educated guess, I would say that the CFPB has likely increased the cost of consumer credit by at least 2 full percentage points.

Wright and Evans use their prediction of 160 basis points to estimate that the CFPB would reduce net new jobs created in the economy by 4.3 percent. Accepting that their predicted increase in borrowing costs is likely low, we can surmise that net new jobs created has been reduced since the establishment of the CFPB by at least 5 percent. This translates to approximately 150,000 fewer jobs that have been created, that would have otherwise, since the CFPB opened its doors.

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[2] The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit, by Joshua Wright and David Evans, George Mason Law & Economics Research Paper No. 09-50 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1483906

Standards for Regulatory Consideration

Under Section 1022(b)(2)(A)(i) of the Dodd-Frank Act, the CFPB is required to consider "the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products of services resulting from such rule." Without question the CFPB is required by statute to consider the impact of its rules on consumer access to credit. Unfortunately I believe the CFPB has failed in this regard, giving little consideration to reductions in access.

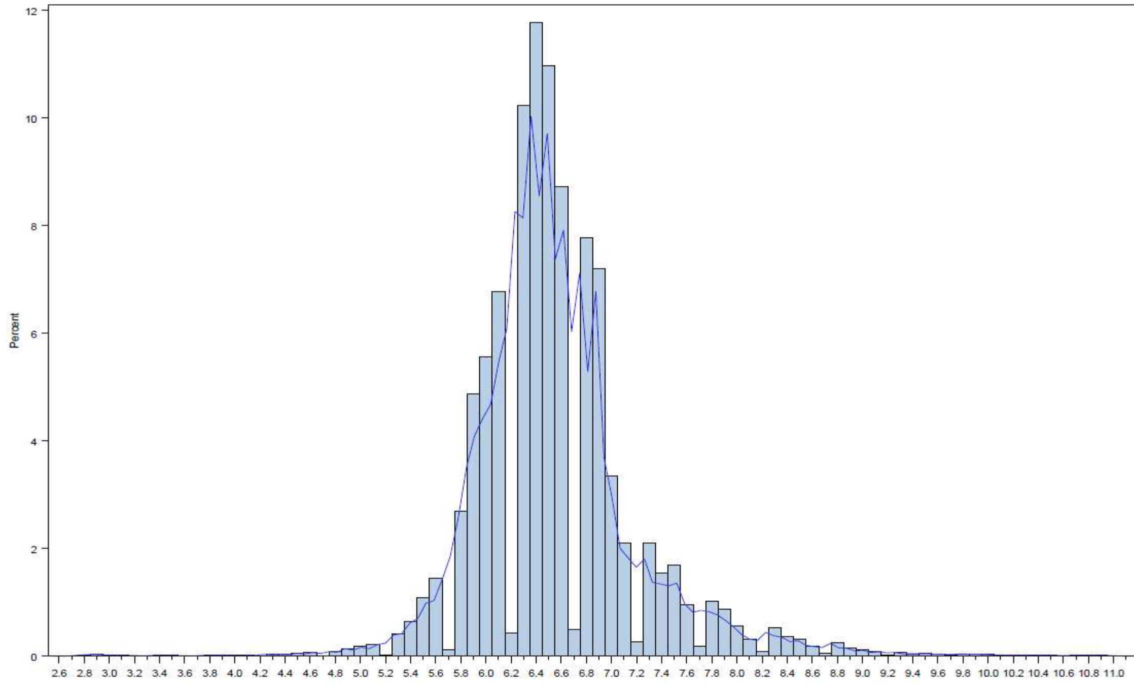
Part of the problem is the CFPB's structure where the Research area, which conducts cost-benefit analysis, is under the same Associate Director responsible for the rule-making. The cost-benefit analysis will not be independent of the rule-making process under such circumstances. I would urge the CFPB to establish an independent economics/research function that reports directly to the Director. As we have repeatedly seen with other agencies, the cost-benefit analysis has simply been an after-the-fact box-checking exercise, rather than a serious attempt to inform the rule-making process.

Conclusions

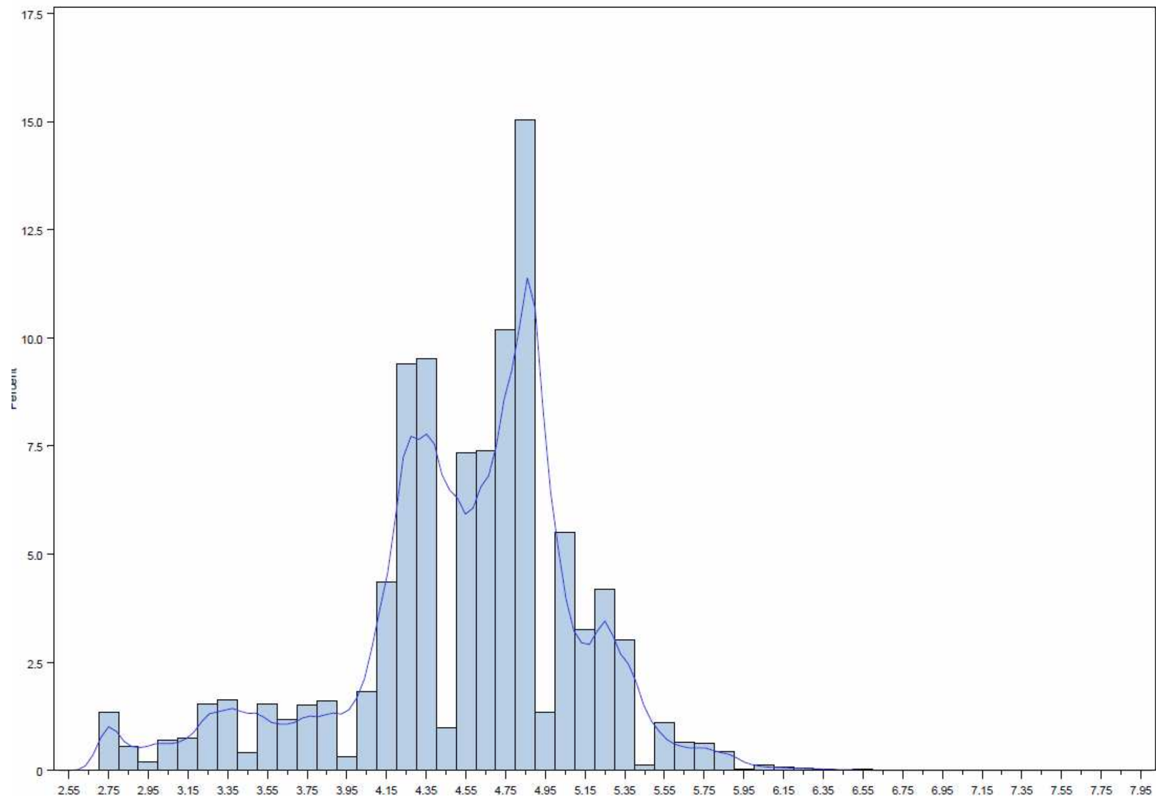
In closing I would like to emphasis that the CFPB is only one of the many obstacles to job creation and consumer credit in our economy. Restructuring or eliminating the agency would certainly improve outcomes, both for our economy and consumers in general, but such a change alone would be insufficient to cure everything holding back our economy. The CFPB's structure is only part of its problem. Of greater concern is the flawed body of consumer protection law inherited by the CFPB. This body of law did not prevent the financial crisis, despite the fact that pre-crisis our mortgage and credit markets were extensively regulated. In fact it was this extensive regulation that contributed to the crisis. Eliminating or restructuring the CFPB in the absence of significant change to the underlying statutes would offer only modest improvements.

I thank you for your attention and look forward to your comments and questions.

2006



2011



Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name: Mark Calabria

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2009. Include the source and amount of each grant or contract.

None

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

None

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2009, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

None

I certify that the above information is true and correct.
Signature: Date: July 23, 2012