

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



Making Financial Markets Safer for Consumers

INSIDE:

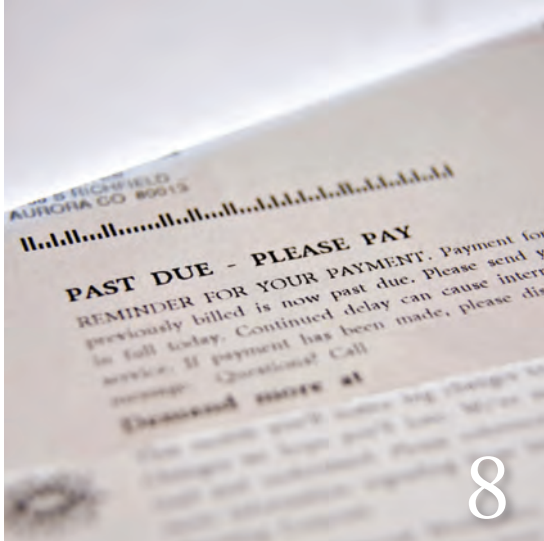
How to Rein in
Systemically Important Institutions

The Curious Case of
Cleveland's Foreclosure Rate

Q&A with Urban Economist
Matthew Kahn

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Forefront
Federal Reserve Bank of Cleveland
PO Box 6387
Cleveland, OH 44101-1387

forefront@clev.frb.org
clevelandfed.org/forefront

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President and CEO: Sandra Pianalto

Editor-In-Chief: Mark Sniderman,
Executive Vice President and Chief Policy Officer

Managing Editor: Robin Ratliff

Editor: Doug Campbell

Associate Editors: Amy Koehnen, Michele Lachman

Art Director: Michael Galka

Designer: Natalie Bashkin

Web Managers: Stephen Gracey, David Toth

Contributors:

Jean Burson

Thomas Fitzpatrick

Daniel Littman

Todd Morgano

Mary Helen Petrus

Francisca Richter

Guhan Venkatu

Stephan Whitaker

Editorial Board:

Ruth Clevenger, Vice President, Community Development

Stephen Ong, Vice President, Supervision and Regulation

James Savage, Vice President, Public Affairs

Mark Schweitzer, Senior Vice President, Research

James Thomson, Vice President, Policy Analysis

Fed: Say Goodbye to Hidden Overdraft and Gift Card Fees

The Federal Reserve recently took steps to shore up consumer protection rules on two fronts—the first dealing with overdraft fees, the second with retail gift cards.

Under rules that will take effect next summer, banks can no longer charge overdraft fees on point-of-sale and ATM debit card transactions without explicit customer permission. Customers can either sign a document opting in to their banks' overdraft protection policies, or they can opt out and forgo overdraft protection on debit card transactions (in which case their transaction would simply be denied). U.S. banks today collect about \$38 billion a year in overdraft fees, although that figure includes fees for checks and some electronic transactions not covered by the new rules.

In the past, disclosure of overdraft fees for debit cards tended to be lumped in with overdraft protection for checks. Research has shown, though, that consumers are more frustrated by fees applied to overdrafts on point-of-sale or ATM transactions than on those that involve checks.

The innovation with the new opt-in rules is that it helps ensure that consumers pay attention. "The assumption is that if you require a consumer to opt-out, that requires them to take action they may or may not have otherwise taken depending on their level of interest or concern," says Paul Kaboth, assistant vice president in Supervision and Regulation at the Federal Reserve Bank of Cleveland. "With an opt-in, you will clearly delineate those consumers who want that service from those who aren't paying attention."

Separately, the Fed has proposed new rules that would place restrictions on gift card expiration dates as well as on inactivity or service fees associated with the cards.

The proposed rules, which would take effect in August 2010, require



Paul Kaboth

that retailers provide "clear and conspicuous" disclosures of inactivity fees, which could be assessed only after a full year of inactivity and then charged no more than once per month. Expiration dates would extend to at least five years after the card is issued or the funds are loaded.

The Federal Reserve began accepting comments on the proposal in November and will review them before announcing the final rules.

About 95 percent of Americans have received or bought gift cards. In 2008, they spent \$88 billion on them. "It would put some order in the marketplace by adding some universal standards," Kaboth says.

—Doug Campbell, editor

Regulating the Raters: Key Provisions in Proposed Reforms

The financial crisis has produced no shortage of culprits—from Wall Street executives who were highly compensated for taking excessive risks to woefully undercapitalized insurance companies. Then there are the so-called credit rating organizations, or CROs, which have largely flown under the radar. How was it possible that CROs such as Moody's and Standard & Poor's handed out so many high-quality ratings to investment vehicles that turned out to be so high-risk?



Thomas J. Fitzpatrick IV

Regulators have long viewed CROs as financial gatekeepers and counted on them to provide investors with impartial assessments of companies' creditworthiness or pools of assets. As a result, some institutions have relied on CRO ratings instead of due diligence.

Academics have been calling for rating organization reforms for years, and their calls became more urgent after the housing crash. When foreclosures began to mount in 2006, CROs at first did nothing. Then, on July 10, 2007, the nation's two largest CROs downgraded \$20 billion of subprime mortgage-backed securities, causing enormous losses throughout the financial system. A month later, the Securities and Exchange Commission (SEC) launched a formal investigation of the CROs.

In its 2008 report, the SEC described CROs' failings in detail. Among the most glaring deficiencies reported was that none of the leading CROs kept specific, comprehensive written procedures for rating subprime mortgage-backed securities and the structured investment vehicles known as collateralized debt obligations. At the same time, CROs' internal emails suggested they were rating deals that their analysts thought should not be rated.

Today, calls for reform are leading to regulatory proposals, including one that would create an SEC office dedicated to CRO oversight. These proposals tend to focus on five areas:

- ending regulatory reliance on CROs

- ensuring that CROs provide new disclosures
- increasing competition
- reducing conflicts of interest
- ensuring that CROs establish adequate internal controls

Ending Regulatory

Reliance on Credit Ratings

Government supervisors use ratings to limit the types of assets regulated institutions can hold. As it stands, CROs are effectively government-sanctioned gatekeepers, creating a market for credit ratings sometimes regardless of their quality. At the same time, it is hard to unwind the extensive regulatory reliance on credit ratings, which are referenced in scores of statutes, regulations, and interpretive letters.

One way to encourage long-term reform on this front would be to give a government supervisor the mandate to work toward ending regulatory reliance on CRO ratings, building on the decades of research already conducted.

Providing New Disclosures

In the past, CROs were forthcoming about their credit rating methodologies and how traditional ratings (such as those for corporate bonds) differ from structured ratings (such as those for asset-backed securities). The assumptions underlying those methodologies, however, have not been available to the investing public. Moreover, the difference between structured products and traditional corporate bonds is not captured in the ratings symbols. For instance, both corporate bonds and mortgage-backed securities can be rated AAA (or Aaa), but their risk characteristics are materially different.

Those are conspicuous omissions. To fully inform ratings users, it is necessary to disclose underlying assumptions, especially the likelihood of a default and the loss it would cause. Adopting new symbols for structured products would signal that these products differ from traditional ones. The new symbols would also make structured products ineligible for satisfying many regulatory requirements that are based on traditional “investment grade” symbols.

Increasing Competition

The CRO market is heavily concentrated. In 2006, the SEC certified only five companies as nationally recognized statistical rating organizations. Just two of the five held 80 percent of the market by revenue and 99 percent of publicly traded debt and preferred stock. Subsequent efforts to encourage new entrants have not yielded results.

Reformers aim to increase competition by requiring all CROs to register with the SEC. Their premise is that there will be increased demand for CROs other than the “big three” if they all have the same government seal of approval. Registration, however, does not guarantee price and quality competition, and empirical research suggests it will not improve the accuracy of ratings. Furthermore, the regulatory burden imposed on registered CROs may make this provision harmful to small organizations with limited resources to spend on compliance.

Reducing Conflicts of Interest

The SEC’s 2008 investigation highlighted two major conflicts of interest: First, issuers, who seek the highest possible ratings, pay CROs to rate them. Second, CROs sell advice on structuring products before rating those products.

Research has shown that the first conflict could cause some issuers to pressure CROs for inflated ratings that would make the issuer’s products more attractive to investors. The SEC’s report found evidence of ratings shopping, for example. To make this conflict more transparent, one recommendation would require CROs to disclose the number of ratings an issuer and its affiliates pay for. It would also require CROs to disclose fees charged for the most recent rating and total fees charged over the previous two years.

Ensuring Adequate Internal Controls

The SEC found that CROs did not effectively implement systems to monitor their regulatory compliance. One way to address this problem is to require that CROs establish procedures to ensure compliance. They would also have to designate a compliance officer who would take primary responsibility for implementing systems of internal controls, due diligence, methodology, and ratings surveillance.

The Upshot

Naturally, it is difficult to predict the effects any reform will have on CROs and the credit ratings market. However, it is essential to address the problems identified by the SEC and scholarly critics of CROs. Legislation itself need not address every problem. If regulators have rule-writing authority, they can use flexibility and creativity to keep recent history from repeating itself.

—Thomas J. Fitzpatrick IV, economist