

Forefront

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



Making Financial Markets Safer for Consumers

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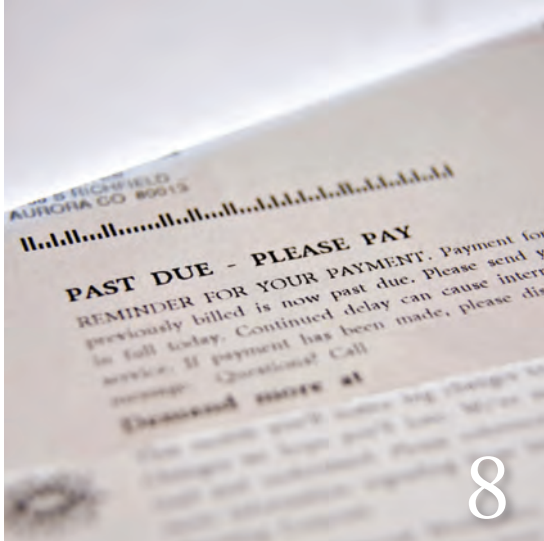
How to Rein in
Systemically Important Institutions

The Curious Case of
Cleveland's Foreclosure Rate

Q&A with Urban Economist
Matthew Kahn

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PRESIDENT'S MESSAGE

Sandra Pianalto

President and Chief Executive Officer
Federal Reserve Bank of Cleveland



We're out there talking. In the face of the most wrenching economic crisis since the Great Depression, the Federal Reserve has stepped up its communications program over the past couple of

years. Chairman Ben Bernanke has added to his already packed schedule of testimony and speeches, held town hall meetings, and appeared on *60 Minutes*. A number of Reserve Banks are now on Twitter. You can find clips of my own speeches, as well as a series of entertaining and informative Drawing Board videos, on YouTube. The Federal Reserve Bank of Cleveland is even on Facebook.

All of this communicating is done with purpose. We at the Federal Reserve believe that a well-informed public is crucial to our efforts in fulfilling our dual mandate of price stability and maximum sustainable economic growth. The more you know, the easier it is for us to do our job. This is particularly true in these turbulent economic times.

We also believe that a decentralized central bank is essential to keeping the interests of Main Street and Wall Street balanced as we conduct monetary policy. An independent Federal Reserve System, with the Board of Governors in Washington, DC, and the 12 Reserve Banks across the country, brings regional conditions and concerns to the policy table, free from political overtones.

In that spirit, I welcome you to *Forefront*, the Federal Reserve Bank of Cleveland's new policy magazine. Whether online or in print, *Forefront* is our vehicle for advancing ideas on economic policy. The language will be clear, the concepts accessible. Although many articles will be penned by highly trained economists, you don't have to hold a PhD to understand them. *Forefront* is not homework. But it is informative.

Our premiere issue focuses on the sometimes complicated topic of regulatory reform. We take a look at consumer protection through the lens of a recent seminar that our Bank hosted in Cleveland. Some of the nation's top researchers in consumer protection gathered to discuss new approaches, building from lessons learned in products beyond financial services, from food and drugs to internet marketing. We also explain our favored approach for regulating large financial institutions to avoid the turmoil that visited the financial system in 2008.

With *Forefront*, we hope to give you a glimpse into the policy-making decisions happening inside our Bank. But we don't want this to be a one-sided conversation. In fact, it is through my contacts throughout the Fourth Federal Reserve District that I develop my views on the most important policy issues of the day—the classic Main Street to Wall Street connection. We'd like to hear from you: What do you think of *Forefront*? Do you agree with our economists on consumer protection? How can we make housing policy more effective?

Please help us contribute to better policy by sharing your perspective. You can comment on specific articles at www.clevelandfed.org/forefront, or email us at forefront@clev.frb.org. We look forward to hearing from you. ■

Housing and the Federal Reserve

Sandra Pianalto
President and CEO
Federal Reserve Bank of Cleveland

**The Federal Reserve influences the housing sector through three key roles:
as a monetary policymaker; as a banking regulator;
and as a community development collaborator.**

This article is based on remarks presented at the Ohio Housing Conference, Columbus, Ohio, November 17, 2009.

As a national policymaker, living through the recent economic crisis has been a humbling experience. It has been sobering to realize that financial market participants and regulators alike did not fully appreciate how complex and interconnected our financial markets had become. Nor did we fully appreciate how much risk was building up in the financial system. These are a few of the many lessons all of us have learned over the past couple of years.

At the Federal Reserve, we now have a better understanding of the conditions that led to the challenges we face, but understanding alone isn't enough. We have been responding vigorously on many fronts—including working to find solutions to the problems of delinquencies, foreclosures, and access to credit—and there is still more work to do. Progress is being made, but it will take the work of many and a considerable amount of time for housing markets to fully recover.

I want to share some of the Federal Reserve's efforts on the housing front. I will first discuss the role of the Federal Reserve as a monetary policymaker and the actions we have been taking to put the economy on the road to recovery. I will then address the regulatory steps we are taking to ensure the safety of the financial sector and to protect consumers and borrowers. I will conclude by detailing our activities here in Ohio and across our Federal Reserve District as a community development partner.

How Monetary Policy Can Affect Housing

The combination of this severe housing contraction and the steep national recession is not a coincidence. During the boom years leading up to this debacle, housing finance became intertwined with broader financial and economic developments. Rising property values supported more consumer spending, banking profits, and more lending of all kinds. When this growth cycle began to unwind, and spin in the other direction, mortgage-related losses eroded the capital of many financial institutions and cut deeply into the wealth of many homeowners. These problems led financial institutions to reduce lending to consumers and businesses, and induced consumers to curtail their spending. Weakness in the housing markets restrained the broader economy which, in turn, further weakened the housing markets.

The Federal Reserve has taken historic measures to address these problems. Monetary policy is the responsibility of the Federal Open Market Committee, or FOMC, which consists of the members of the Board of Governors in Washington, DC, and the 12 Reserve Bank presidents from across the nation. This decentralized structure ensures that the Committee takes into account Main Street as well as Wall Street. The FOMC has a dual mandate from Congress—to maintain price stability and to promote maximum sustainable economic growth.

When economic activity weakens, the FOMC typically lowers its short-term policy target, known as the federal funds rate, and this time was no exception. As the outlook for the economy deteriorated, the FOMC repeatedly cut the federal funds rate target, and it now stands at essentially zero.

This recession has been far from a typical one, however. Many financial markets seized up, crippling the flow of credit to many parts of the economy, including such important Main Street activities as housing finance, auto loans, and even student loans. Federal Reserve officials knew that we had to do more than rely on interest rate actions alone. Beginning in the spring of 2008, we designed a number of new lending programs and facilities to get credit flowing once again to these important financial markets. Our objective was to help thaw a broad range of financial markets and steer the wider economy away from a cliff.

We have also taken unprecedented steps in how we conduct monetary policy. For instance, we have been purchasing mortgage-backed securities issued by the government-sponsored enterprises Freddie Mac, Fannie Mae, and Ginnie Mae. Our strategy has been to reduce the cost and increase the availability of credit for home purchases, which we expected would support housing and financial markets more generally. We are now well into this program, which will culminate in the purchase of \$1.25 trillion in agency mortgage-backed securities by next spring. Today, mortgage rates stand more than a full percentage point lower than they were one year ago.

Fortunately, we have seen some recent progress in the housing sector. Housing prices and sales levels have begun to stabilize, and in the first half of the year, refinancing was up by more than 150 percent, which has lowered the debt burden of many homeowners. Of course, the Administration and Congress also had a strong hand in helping to stabilize real estate markets — most notably with the first-time homebuyer tax credit. The combined efforts of these initiatives seem to be working. Three out of five home sales are now to first-time buyers, compared with one in five in a typical market. But this also illustrates that many move-up home purchasers are still sitting on the sidelines, so there is a long way to go before anyone can breathe a sigh of relief.

At this point, monetary policy can most effectively support the housing sector by fostering stronger growth in the broader economy, which would lead to more stable property values, increased consumer confidence, and lower unemployment. Economic conditions have certainly improved since the beginning of this year, but resource utilization levels still remain low, bank lending is restrained, and credit terms are tight. I expect our recovery to be a gradual and bumpy one.

Responding to Regulatory Issues

The Federal Reserve's supervisory and regulatory roles also affect the housing sector. While much of the initial financial crisis originated in the mortgage markets, there is still much to correct there and in the broader financial markets.

Everyone with a role and a stake in the financial system needs to take a careful look at the various failures of market incentives and regulations that supported mortgages and securities that are now being described as “toxic.” In looking at what went wrong, we need to react in a thorough and thoughtful manner to limit similar problems in the future. We at the Federal Reserve have been examining our past actions to understand where opportunities are available for strengthening our supervisory approach. Where we can act under existing authorities, we are taking strong steps to make our financial system safe, sound, and fair.

We have broadened the scope of our supervision. For example, we have heard complaints that while a given bank might be complying with regulations, one of the same bank's holding company affiliates might not be. To address this issue, the Federal Reserve announced that we will conduct consumer compliance exams of nonbank subsidiaries of bank holding companies and foreign banking organizations, and we will investigate consumer complaints against them. Our goal is to ensure consistent practices within all subsidiaries of bank holding companies, not just banks.

In addition to these and other supervisory efforts, the Federal Reserve has adopted new regulations and revised existing ones to protect consumers. In July 2008, the Federal Reserve strengthened a key regulation designed to protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices. The rule also establishes advertising standards, requires certain mortgage disclosures to be given to consumers earlier in the transaction, and adds important protections for a newly defined category of “higher-priced mortgage loans.” When developing new regulations, the Board of Governors is working carefully and creatively to craft regulations that people can better understand — even using consumer focus groups to give us feedback on the clarity of our proposals.

The Federal Reserve also has rule-writing authority for the provisions of the Community Reinvestment Act (CRA). The CRA has been a significant driver of access to credit and capital in traditionally under-served communities since it was passed in 1977. Yet the financial services landscape has changed dramatically in the past 30 years, and the problems we face are now different.

For example, there is evidence that the CRA is of limited use in addressing the problem of foreclosure spillovers, especially when it comes to dealing with real-estate-owned (REO) properties and the disposition of vacant properties. This is an especially important issue for Ohio, which is saddled with a very high inventory of REO properties.

The CRA was designed to encourage banks to support building and renovation, not to tear down dilapidated housing. But one of the CRA's hallmarks is its flexibility. There may be ways to adapt the regulation to encourage lenders to support the kinds of housing activities that many communities need in this time of crisis. I think the CRA can become a more effective tool in providing incentives for banks to donate some of the distressed real estate they own to qualified community development corporations, and to engage in services and investments that benefit foreclosure mitigation and neighborhood recovery efforts. The Federal Reserve Bank of Cleveland is currently working with others on a practical way to adapt the CRA for these purposes, although ultimately, changes in CRA regulations involve the other bank regulatory agencies in addition to the Federal Reserve.

Proactive Steps by Community Development

While regulatory efforts are important, regulation alone is not a panacea and often addresses problems only after they have become problems. Despite renewed activity on the regulatory front by the Federal Reserve and others, we need strategies to tackle the wider housing challenges of today and tomorrow. This raises the third area of focus for the Federal Reserve: our work as a community development partner.

Through the Community Development function at each of the 12 Reserve Banks, the Federal Reserve maintains relationships with community and economic development practitioners. We regularly share our findings with bankers and legislators at the state and national levels, and with our colleagues at the Board of Governors in Washington. And we use the knowledge we gain to inform our supervisory and regulatory policy responsibilities.

We also apply this knowledge in our work with other government agencies at all levels to promote community development. This leads to more flexible and targeted solutions that can make a difference in all neighborhoods.

At the Federal Reserve Bank of Cleveland, a critical theme that has surfaced from our community development work—and that continues to guide our efforts—is that recovery in Ohio will be affected by the challenges we face as a slow-growth region, where population declines over the years left a serious excess of housing well before the crisis began.

Even though Ohio never experienced the sharp appreciation in housing prices that other parts of the country did earlier in this decade, the pain of the crisis has been just as real here, if not more so. In some parts of Ohio, housing sales began to weaken as early as 2004. Simply put, Ohio's problems are more entrenched because they are tied to structural and not just cyclical weaknesses in the state's economy.

This makes it all the more necessary to investigate what housing programs might work within our region. Last November, we held a series of public events to connect distressed borrowers, counselors, and loan servicers to find ways to keep people in their homes. At that time, we thought loan modifications would prove to be an important tool for stabilizing the housing market. Outreach to distressed borrowers has met with mixed success, and only a very small percentage of distressed loans has been modified successfully across the nation—and the figure has been even lower here in Ohio.

Well-intended efforts often do not work well in practice for any number of reasons. We discovered a variety of factors that inhibited the loan modification process, some of which are currently being addressed by lenders, servicers, counseling agencies, and program administrators. Other factors are not so easily addressed, such as the fact that many of the mortgage loans that borrowers received were poorly underwritten in the first place.

If a homeowner cannot avoid foreclosure and has to leave his or her home, what happens to the property if it happens to be in a place where there is either no ready buyer or simply too few people left to occupy yet one more empty house among many others? The Neighborhood Stabilization Program, or NSP, was put in place to help municipalities acquire such properties for possible rehabilitation and resale, or in some cases, demolition and land banking. The Federal Reserve Bank of Cleveland and the Federal Reserve Bank of Richmond are partnering with the National Vacant Properties Campaign to conduct case studies of different kinds of communities that receive NSP funds to find out where the NSP is working, and where improvements might need to be made. We are sharing our findings here, in our region, and also with the Department of Housing and Urban Development.

Our Community Development office also conducts research and analyzes data to uncover patterns, trends, and relationships in the housing markets. Through this body of knowledge, we are gaining valuable insight into other potential solutions, where problems are occurring, and whether there are any similarities or differences throughout the region that can help improve public policy.

An example of this approach in practice: Data analysis is helping us uncover what factors contributed to very different foreclosure rates in 2007 among demographically similar neighborhoods in Cleveland and Pittsburgh. Cleveland's foreclosure rates are far greater than Pittsburgh's, especially in poor neighborhoods.

One major discovery of our research was that most of the mortgage lending in Cleveland's poorest areas was originated by a small number of nonbank mortgage companies. However, this source of lending was not nearly as much of a problem in Pittsburgh. Residents of poor Cleveland neighborhoods appear to have less access to, or less reliance on, traditional financial service providers.

We are working to understand why such differences exist between the foreclosure experiences of these two communities and where some improvements might be found, such as in the way states regulate and supervise the mortgage origination process. Other opportunities might be found in homeowner counseling and assistance programs.

The work undertaken by the Federal Reserve in the area of community development aims to help low- and moderate-income communities, but none of our community development efforts can possibly offset the losses and hardship that

these communities have experienced. Decades of progress have been wiped away in many low-income communities in this dramatic two-year burst of foreclosures. The Federal Reserve's activities are only a small part of a wider effort.

Time and Teamwork: Keys to Solutions

In conclusion, I want to emphasize that the Federal Reserve recognizes the need for action and that we have been aggressive in monetary policy, banking supervision, consumer protection regulation, and community development. Collectively, these efforts are designed to help restore housing markets in pursuit of a better-functioning economy. However, the scale of the recession, the financial turmoil, and the focused impact of the crisis on many communities pose an unprecedented challenge to all policymakers. While we certainly see ourselves as part of the solution, many partners and much time will be needed to heal these problems.

It's going to take a creative, coordinated, and collaborative effort to get our housing market back on track—especially here in Ohio. That's why I encourage all of our readers to please stay in touch. Let us know what you're thinking and how you think we can help. ■



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



Making Financial Markets Safer for Consumers: Lessons from Consumer Goods Markets and Beyond



Thomas J. Fitzpatrick IV,
Economist



Daniel Littman,
Economist



Stephan Whitaker,
Research Economist

In the wake of the mortgage meltdown, policymakers are discussing how best to protect consumers in financial product markets. The Federal Reserve Bank of Cleveland hosted a seminar, “Consumer Protection in Financial Product Markets,” in September 2009 to exchange ideas with other regulators about consumer protection and the role of the courts. Conference participants zeroed in on four areas of reform:

- Increasing oversight of lightly regulated lenders
- Ensuring that disclosure statements are rigorously tested for comprehensibility and effectiveness
- Encouraging market interventions that make comparison shopping easier
- Introducing new legal requirements that firms match buyers with the most suitable products

Some mainstay economic principles were suggested to guide reforms, such as supporting competition and consumer choice, and strengthening borrowers’ and lenders’ incentives to deal in safer products.

All quotations in this article come from discussions and panelists’ statements during the conference.

The Exploding Toaster Analogy

The exploding toaster holds a special place in consumer protection lore. It is obviously an unsafe product: If they knew about the danger, consumers would not buy the toaster and regulators would pull it off store shelves. The exploding toaster analogy highlights the differences between consumer goods markets and the often more complicated market for financial services. Some believe that although consumers wouldn’t knowingly buy an exploding toaster, in the past few years millions of them took out an “exploding mortgage.”

Granted, this is a simplified analogy. But it underlines the observation that ordinary consumer goods seem a lot safer than some financial products. How do consumer goods markets—and their regulators—differ from consumer finance markets?

Quite a bit, actually.

For some time, consumer finance regulation in this country has been guided by a couple of fundamental (and still true) economic principles: First, competition usually works in consumers’ favor. It lowers prices, raises quality, and gives people more choices. Second, information, often in the form of disclosures, helps consumers understand a product’s strengths and weaknesses.

Both of those notions have been tested in the current financial crisis. Competition was intense, to judge by the sheer number of mortgage brokers and lenders. Unfortunately, competition did not always translate into high-quality, affordable products for consumers.

How about disclosures? Anyone who has been to a mortgage signing ceremony has witnessed the lengthy

disclosures involved in the borrowing process. But borrowers' ability to fully digest and comprehend page after page of disclosures is doubtful.

It is time to step back and re-evaluate our approach to consumer protection in financial markets. To get started, we can examine how a consumer's shopping experience could be affected by product regulation and pre-market approval; information and disclosures; and gatekeepers.

Product Regulation and Pre-Market Approval

In 1970, the National Commission on Product Safety reported to Congress on a two-year study of consumer goods safety. The findings were appalling: a total of 30,000 deaths and 20 million injuries from common household products each year. Lawn mower blades chopped off hands and feet. Infants strangled when they wedged their heads between crib slats. Hair dryers, even when turned off, fell into bathtubs and electrocuted people. Most of these products were labeled clearly with easy-to-understand warnings, but those labels proved disastrously inadequate. Today's regulation of financial products is not much different. Regulators require disclosures, which we assume will protect consumers from harm.

"That was an indifferent marketplace. That was a marketplace where year in and year out, these things were happening, and unless you knew one of those people [the victims], you wouldn't even know this happened," said David Pittle, one of the original five members of the U.S. Consumer Product Safety Commission and former senior vice president for technical policy at Consumers Union.

Today, by federal mandate, lawn mowers shut off within three seconds after the operator lets go of the handle, the spaces between crib slats are too narrow to trap an infant's head, and hair dryers have a ground-fault circuit interrupter that prevents electrocutions. "Those changes don't happen by themselves," Pittle said. "It takes a federal presence to make that happen."

The Consumer Product Safety Commission was formed in 1973. According to Pittle, this was an essential step in identifying safety issues and forcing corrective action. Before the commission was formed, consumer goods were regulated by a variety of agencies and some were completely unregulated. For financial products, the same situation still prevails.

The safety commission's experience shows the power of information gathering. When data for a household product show clear patterns of injury and death, firms can respond—or can be compelled to do so. We have no comprehensive data linking financial products to foreclosures, however. As a result, subprime loan abuses reported early in this decade could be dismissed as isolated incidents.

In addition, products that pose serious potential danger to consumers must have regulatory approval before they go on the market. That is how it works with the processed food and pharmaceuticals overseen by the Food and Drug Administration (FDA), which has partial or full veto power over new product releases.



CHRIS PAPPAS

Legal experts, academics, and government officials presented research, practitioner experiences, and the current state of the law at the Cleveland Fed's September 11, 2009, seminar on consumer protection.

Top row: Mark Sniderman

Fourth row, from left: Stephan Whitaker, Susan Wachter, Kathleen Engel

Third row, from left: Janis Pappalardo, Patricia McCoy

Second row, from left: David Pittle, Gregory Elliehausen, Dan Carpenter, Tom Fitzpatrick

Bottom row, from left: Ray Brescia, Jerry Fons, John Lynch, Creola Johnson, Alan Levy

Harvard political scientist Dan Carpenter argued that the FDA has produced positive outcomes because it has focused on high-quality research, which has benefited food and pharmaceuticals consumers immensely. “In the FDA model for drugs—and I’m not saying it’s the right model for consumer finance—the veto power [to keep products off the market] induces this experimental incentive,” Carpenter said.

After a product has FDA approval based on information rigorously acquired from randomized clinical trials, the product must have clear labeling that tells consumers what it has been approved for. “Institutions are needed as well as markets for the provision of that kind of information,” Carpenter said. “I just don’t think markets [alone] are going to get you there.”

In the case of financial products, some firms already have databases to identify their own potential risks. The issue is whether a regulator can gather comprehensive data for consumer protection, or give firms an incentive to use those data internally to avoid harming consumers.

Standard economic theory would suggest that pre-market approval would decrease supply and eventually would hurt consumers by restricting choice. But several research papers on regulatory standards for food that were established in the early 1900s reached the opposite conclusion: Consumption of processed food greatly expanded in states that adopted standards for regulating food quality.

The notion that regulation can actually spur innovation may also apply to the withdrawal of products from a market. For example, what happened in the early 1970s when the FDA removed mental health drugs that had bad side effects? Pharmaceutical companies conducted research that developed several new drugs, including antidepressants such as Prozac. “In large part, the sort of revolution in psychopharmacology has occurred because we got rid of the lemons in the marketplace,” Carpenter said.

Information and Disclosures

Let’s visit the supermarket. People shopping for low-fat yogurt usually don’t have the means to perform a nutritional analysis, so the FDA requires the manufacturer to provide that information; it also regulates the manufacturers’ claims closely. Yogurt can’t be called low-fat unless it satisfies the FDA’s definition of the term. But even

accurate information, clearly displayed on the carton, doesn’t guarantee that the consumer will make the decision that is best for him. Research shows that very few shoppers turn the yogurt carton around to read the ingredients list and nutritional information on the back.

Many claims are made for financial products as well. Instead of reading a small label, consumers must read through stacks of disclosure statements to test those claims.

The danger with claims, according to Alan Levy, a senior scientist with the FDA, is that they can truncate the search for information. Consumers may get a product that only partly meets their needs, or they may miss out on a much better product.

People read labels because they want to make good decisions. “But their sense of what constitutes a good decision is quite different from a search for truth and the cost–benefit calculation that is often assumed to characterize their choices,” Levy said. “Too much of our policy attention is devoted to perfecting claim language, and not enough is devoted to getting consumers to ask better questions.”

If product labels aren’t enough, what else can be done? John Lynch, a University of Colorado psychologist who studies consumers’ decisionmaking, thinks that the most significant predictor of choice is whether the product is in the consumer’s “consideration set” in the first place. “For an option to be chosen, it has to be considered. It sounds obvious, but it’s profound,” Lynch said. “Most of the time when an option is not chosen, it’s not because it was examined and found wanting. Rather, it was not even considered.”

This brings us to the concept of nudging. Richard Thaler and Cass Sunstein wrote the book that made the term famous. “A nudge is trying to help consumers make better decisions by changing the choice context subtly or by changing defaults that make the most likely mistakes less likely,” Lynch said. Nudges preserve choice but subtly direct people either to the choice that is best for them or to the most socially desirable choice. The authors have called it “libertarian paternalism.”

Nudging has shown some promising results. For example, it is becoming standard practice to make 401(k)s the default choice when employees sign up for benefits. That means that employees must opt out if they don’t want to

set up a company-sponsored retirement savings plan. The optimal decision—to participate—is the same however it is reached. But with opt-out nudging, more employees make the optimal choice because of the way it's offered to them. Similarly, European countries with opt-out for organ donation programs have about 90 percent participation; only 20 percent participate in countries where donation is opt-in.

This is not to say that disclosures don't matter at all. In a nudging regime, they matter a lot. The least safe products in a consideration set, for example, would have to carry detailed disclosures (see sidebar below).

Gatekeepers

Today's financial instruments are so complicated that an expert gatekeeper is often needed to guide consumers through the selection process, much as doctors are the gatekeepers of prescription medications, and attorneys guide clients through complex legal proceedings.

At the business level, credit rating organizations, such as Moody's and Standard & Poor's, are intended to serve as gatekeepers who evaluate companies' creditworthiness

so that people who buy and sell securities have accurate information. Government regulation makes these ratings the "keys" that open "gates" for investable assets. That is, receiving an investment-grade rating opens a world of investors that would otherwise be closed.

For consumers, mortgage brokers or loan officers are obvious candidates for the role of gatekeeper in home loan markets, said Federal Reserve Bank of Cleveland economist Thomas Fitzpatrick. Many borrowers assume that their mortgage broker has their best interests in mind. "By one study, 40 percent of American adults believe that lenders are lawfully required to give them the best possible rates," Fitzpatrick said. The fact is that no such law exists. Although brokers may not commit fraud and must abide by laws governing unfair or deceptive practices, they have no obligation to get their clients the best rate.

To overcome this problem, Fitzpatrick proposed applying "duty-of-care principles" to the mortgage broker business. Some jurisdictions impose such duties on brokers, but only in circumstances so specific that it is relatively easy to avoid liability.

The Mortgage Decision: How Nudging Might Work

A prospective homeowner logs on to a mortgage recommender website, which could be required, designed, and maintained by a regulator.

- The site asks questions about personal circumstances that affect the borrower's relative level of risk for different loans.
- It inquires about the borrower's preferences about the trade-offs between different loan features.
- Software searches a database with offerings from various providers and recommends five loans that regulators consider safe for the current borrower and that have the characteristics he prefers. The best fits—which might even recommend an optimal down-payment level—head the list.
- A borrower is more likely to investigate at least some options if he is not faced with hundreds of loan products. Having too many choices can overwhelm people, causing them either to avoid purchasing anything or to pick a product without any serious investigation. (This phenomenon has been observed with 401(k) plans: When companies offered hundreds of choices, employees dropped out of the program or chose what they considered "safest," reducing their return on investment.)
- Freedom of choice is maintained. Borrowers can ask to see loans further down the ranking, and even select a loan considered unsafe (off the recommended list), but experience in other contexts suggests that the vast majority will select one of the five suggested loans. As a rule, no loan can be originated without the borrower's signature on a print-out of his "recommended" list.

If the nudging system is optional or only available online, it may fail to reach less-sophisticated consumers, who need it the most. If automating the selection process proves too difficult, a broker who is obligated to select safe products could recommend five products or providers.

As University of Colorado psychologist John Lynch puts it, the recommender system is "a form of a nudge that allows for the possibility that people in different circumstances could be affected by different risk levels for different kinds of loans." In some ways, it resembles



John Lynch

a supermarket for mortgage loans, which organizes products by standards that are relevant to consumers.

Under duty-of-care principles, brokers could be held liable for selling faulty loans, much as investment advisers are liable for violating their fiduciary duty to clients. “A duty of care would allow a borrower to collect [damages] from a broker if that broker violated its duties,” Fitzpatrick said.

But broker liability may not be enough, he warned; it may also be necessary to add a step so that mortgage loan holders could not force a victim of unlawful origination practices to pay the full amount of the loan. “The idea is that once secondary market purchasers are liable, they’re going to start paying more attention to the practices of originators,” Fitzpatrick said.

As evidence, he cited a case from the consumer product market. In the 1970s, people could buy refrigerators by signing a promissory note. The retailer would sell the promissory note to a finance company, which would collect the buyer’s payments. If the refrigerator was defective, the consumer would still have to make payments to the finance company while trying to get compensation from the retailer that sold the faulty product. Consumer complaints mounted until the Federal Trade Commission assigned liability to finance companies. As a result, finance companies changed their contracts by inserting buy-back provisions, which could force the retailer to buy back the notes. The commission’s new rule was not reported to restrict credit or hurt small retailers.

Preserving consumers’ legal claims and defenses “forces the market to internalize those costs and re-price credit appropriately,” Fitzpatrick said. “By many accounts, it’s been effective in accomplishing its goals.”

The details are complex, of course. The roughly 8,000 banks in the country are all closely supervised by state or federal regulators, and often by both. But there are many thousands more mortgage brokers than banks. How specific and flexible should the rules be as the market evolves? Will regulators merely supervise the market, or will violators be prosecuted? Will it be a federal effort? “If we leave it to the states alone, we end up with a patchwork of laws that is somewhat more difficult for companies to comply with if they operate over state lines,” said Pat McCoy, a law professor at the University of Connecticut.

On July 30, 2008, the Fed issued a rule regulating a broad spectrum of mortgages, which it may broaden further. As both Fitzpatrick and McCoy noted, some reformers argue that liability should be imposed not only on brokers and lenders but also on secondary market purchasers, such as the government-sponsored enterprises Fannie Mae and Freddie Mac. That liability would encourage lenders to suggest loans that the borrower has a good chance of repaying, and would encourage secondary market investors to deny funds to firms engaged in fraudulent practices.

A New, Reality-Based Approach

Gatekeeping, product regulation, and pre-market approval already exist in consumer finance—but to a smaller extent than in consumer goods.

The dangers from faulty consumer goods include death, injury, disease, and destruction of property. Financial dangers take the form of bankruptcy, foreclosure, and a diminished standard of living.

The recent financial crisis has shown that disclosure-based regulation of mortgage products is inadequate. Given the comments of the conference participants, how might a new consumer protection regime affect the mortgage market?

- It would track mortgage products by classification according to their risk to better identify dangerous products.
- The concept of disclosure would change from giving consumers all of the details about one product to encouraging and enabling them to comparison shop. This might mean selecting a manageable number of important details and requiring consumers to consider a minimum number of products or providers before entering into a contract.
- There is strong evidence that consumers greatly value convenience and avoid extensive search efforts. Establishing financial services “supermarkets,” perhaps structured as recommender systems, would help make the market more competitive and shopper-friendly.
- Disclosures should be rigorously tested for effectiveness. In the realm of pre-market approval, firms should build and test products for safety before releasing them to the market.

Disclosure Disorder

Competition benefits only those consumers who get honest information. Multipage disclosure forms do not help if they are too complicated for a non-expert to decipher, too long to read in one sitting, and too late to affect the key choices of house and lender. Even diligent shoppers have trouble breaking through the noise.

The Federal Trade Commission's Janis Pappalardo and Jim Lacko noticed that in many deceptive lending cases, disclosure statements had been properly filled out, yet borrowers were still deceived. Their research showed that many borrowers "were unaware of, did not understand, or misunderstood key costs or features of their loans." Did they have up-front points? An ARM? Prepayment penalties? Borrowers were often confused, and for good reason.

Many mortgage disclosure forms tell borrowers to check boxes that offer choices like "may have prepayment penalty" or "may not have prepayment penalty." May? Which is it? "The thing that's really shocking was that, in some respects, the disclosures were worse than ineffective," Pappalardo said. "They actually seemed to create consumer misunderstandings."

More information is not the solution. Simplicity would be a step in the right direction, but what's really needed is solid, objective, quantitative testing of disclosure forms. The results would help regulators take into account consumers' preferences, differing educational backgrounds, and time constraints.



■ Incentives for firms and gatekeepers should be aligned with the interests of consumers. The costs of providing unsafe products should be internalized: If a borrower is unlawfully led into a loan product—perhaps deceived or tricked with fraudulent promises—he should be able to use the loan originator's unlawful conduct as a defense against paying on the loan, no matter who currently owns it. If loan purchasers were made liable for originators' conduct in this way, purchasers would insure themselves against such losses and could spread the cost across all borrowers, instead of externalizing or passing it off on the wronged borrowers.

To understand why consumer protection in financial product markets misfired during the mortgage meltdown, it is instructive to think about some of the factors that play into people's decisions.

First, people respond to incentives. Second, they differ from one another in their preferences, financial means, and time constraints and generally choose what seems best for them over the long term.

Therein lies the challenge in consumer finance markets. Products like adjustable-rate mortgages (ARMs) or payday loans are far more complicated to use than toasters. How do you structure incentives so that consumers make the choices that best suit their preferences, incomes, and time constraints?

For instance, many would consider an ARM with prepayment penalties the financial equivalent of an exploding toaster, but it's not necessarily so. A borrower who is fully informed about his options—and the risks of each—might still choose an ARM, and it might well be the best choice. For this borrower, the mortgage probably won't explode.

That's because credit helps people smooth their lifetime income. Janis Pappalardo, a Federal Trade Commission economist who looked into consumers' different ways of making choices, came away convinced that we should not jump to conclusions when it comes to consumer behavior. "One person came in with an ARM—I think it was a piggyback [a second loan used in place of a down payment]—and he knew exactly why he was doing it," Pappalardo said. "He was in graduate school. His future income stream was going to be going up, so it was the right deal for him."

That lesson is as important as any: Consumer protection can go too far. The trick is to find an equilibrium between helping people choose and making sure they are free to make the choices that are best for them. ■



Papers and Presentations

Consumer Protection in Financial Product Markets, a Sept. 11, 2009 conference. www.clevelandfed.org/research/Conferences/2009/9_10-11-2009/index.cfm

A Framework for Systemically Important Institutions

Too big to fail or not too big to fail—that, it turns out, is *not* the question.



Jean Burson,
Policy Advisor

This article is based on James Thomson's "On Systemically Important Financial Institutions and Progressive Systemic Mitigation," Federal Reserve Bank of Cleveland Policy Discussion Paper, August 2009.

The too big to fail problem is not an either-or proposition. Sometimes a firm is systemically important—with the potential to endanger the broader financial system if it fails. Other times, the same or a similar firm may not be systemically important. And while size can sometimes be the essential criterion for determining whether a firm is systemically important, the definition also depends on the circumstances and characteristics of a particular institution.

Was Bear Stearns too big to fail? In the spring of 2008, federal regulators thought so. They quickly moved to provide financial backing for a sale. But confusion lingered among market watchers over what precisely made Bear Stearns important on a systemic scale. Was Lehman Brothers too big to fail? In the fall of 2008, federal regulators didn't think so. But the rapid deterioration of the financial markets following the bankruptcy of Lehman

Brothers has led some to conclude that in hindsight, it was systemically important in the context of the fragile market conditions at the time of its collapse.

These twin cases underline the need for a framework to classify systemically important institutions. By framework, we mean a comprehensive method for determining—on a case-by-case, moment-by-moment basis—just which firms are too big to fail. From there, it is much easier for policymakers to craft a response.

A first step is to recognize that two institutions might be considered systemically important for unrelated reasons. For example, a firm might be systemically important simply because of its size—in terms of revenue, employees, or assets. In this category, we almost certainly can include top financial institutions such as CitiGroup and Bank of America.

Another firm might be considered systemically important because it is a major player—or the only player—in an important financial market. The insurance giant AIG Corp., for example, was by far the leading seller of credit default swaps (CDS). When AIG couldn't live up to its promises to pay off buyers of CDS instruments, its imminent failure would have likewise toppled scores of counterparties.

Still another institution might not be systemically important in its own right, but when considered as part of a group of institutions engaged in similar activities or exposed to common risks, the collective activities of that group create the potential for systemic risk. The recent meltdown in the subprime mortgage market is just such a case—since “everybody” was doing it, the risk increased far beyond what it would have been had only a few firms engaged in this type of lending. A number of factors and permutations of factors can present systemic risk, creating a formidable challenge for any regulator or policymaker.

It would be a mistake to go into regulatory overdrive and impose new requirements on all financial institutions in the wake of the 2008–09 financial crisis. When the pendulum swings toward an overly restrictive regulatory environment, innovation is stifled and the economy’s long-term growth potential suffers. A more effective framework is consistent with longer-term regulatory goals, allows the sources of systemic risk to be managed without unduly increasing regulatory burden, and creates disincentives for firms to become systemically important in the first place.

The Four C’s

The framework begins with the four C’s of systemic importance: contagion, correlation, concentration, and context.

Contagion occurs when one firm’s insolvency affects other firms connected to it. These connections might result from intertwined loans, deposits, or other types of financial relationships. Eventually, a chain reaction can begin that could threaten the entire financial system.

This domino effect of contagion can be thought of as the *too connected to fail* problem. It was contagion that prompted the Federal Reserve Bank of New York to arrange the acquisition of Bear Stearns by JP Morgan Chase based on the very real potential for spiraling losses among players in the mostly unregulated credit default swaps market. Because contracts were not traded through a centralized exchange, the total exposure of all counterparties was not known. Regulators were concerned that sellers might not have been able to meet their net obligations on contracts related to such a large and presumably solvent institution. Companies holding positions on Bear Stearns might have been perceived as risky, potentially resulting in runs on those institutions even if they were fully capable of meeting those obligations.

Correlation as a source of systemic importance can be thought of as the *too many to fail* problem. Two aspects of correlation risk are important for policymakers to consider. First, institutions have clear incentives to take on risks that affect other institutions, recognizing that regulators will be unlikely to allow any one of these institutions to fail. For example, financial institutions were willing to assume widespread exposure to subprime mortgages, mortgage-backed securities, and products related to mortgage-backed securities over the past decade. At some level, it was understood that regulators would be likely to bail out troubled firms rather than allowing all of them to fail.

When the pendulum swings toward an overly restrictive regulatory environment, innovation is stifled and the economy’s long-term growth potential suffers.

A second source of correlation risk occurs when activities that appear to be unrelated during normal times become highly correlated during periods of financial stress. This behavior occurs when many institutions take similar actions in response to a development in the economy. Consider the fallout, for example, if a large group of hedge funds took similar positions on oil prices; a price shock would lead the hedge funds to reverse their positions all at the same time. Those synchronized activities can suddenly present systemic risk.

Correlation presents a particularly significant challenge for policymakers because it can be difficult to classify a group of institutions as presenting systemic risk before the trouble starts. An important first step in defining appropriate regulatory treatments is to determine what

What Is a Stress Test?

A stress test tries to determine whether a financial institution could survive under some very bad economic conditions. For instance, the stress test used earlier this year for the nation’s leading financial institutions challenged whether a bank’s balance sheet could hold up in the face of 11 percent unemployment, or if home prices crashed by 25 percent. How many loans would default under such a scenario, and what would happen to a bank’s capital base as a result?

Depending on the results, regulators might require institutions to raise more capital to ensure that they could endure a lengthy slump. Last spring, stress tests of the nation’s 19 largest banks showed 10 of them needed a larger capital buffer. Those 10 quickly responded with plans to sell more stock or raise capital in other ways.

Not Too Big to Fail After All



GETTY IMAGES

The story of how Drexel Burnham Lambert was forced into bankruptcy is a painfully familiar one. For most of the 1980s, the firm made its living in relatively low-rated “junk” bonds—debt of other companies whose ability to repay was judged as fair at best. One day in early 1990, one of Drexel’s creditors declined to

renew a \$30 million credit line. Given that Drexel’s bond portfolio was mostly illiquid, Drexel was suddenly in the position of not being able to meet its ongoing debt obligations. The firm tried to persuade both private banks and the Federal Reserve to provide a lifeline, arguing that its collapse would have serious ripple effects.

But regulators determined that the securities markets would be able to endure in the face of a Drexel meltdown—and they did. Although the losses were large, most creditors turned out to have sufficient cash reserves to weather the fallout.

level of correlation across portfolios poses a systemic threat through the development of stress testing, scenario analysis, and comprehensive risk management tools. In fact, the type of risk modeling and scenario analysis required is already taking place in many large financial institutions.

Concentration as a source of systemic importance can be thought of in the classic sense of the definition of *too big to fail*: An institution has a highly concentrated market share of assets, loans, and deposits. However, even a firm that might not be considered too big to fail based on size can present systemic risk due to a concentration of activities. Firms that dominate key financial markets or payments systems therefore require careful monitoring. The previously mentioned dominance of AIG in the credit default swaps market is an example of how concentration can elevate a large, complex institution to a systemically important one.

Context becomes a source of systemic importance when regulators are reluctant to recognize the failure of a distressed financial institution under fragile economic or financial market conditions. This same firm would be allowed to fail under more normal conditions. Firms that might be systemically important based on context are often the most difficult to identify before conditions deteriorate, but stress testing and scenario analysis can help spot potential candidates and the likelihood and impact of triggering events. When anticipating these types of events, regulators need to consider that during periods of financial market distress, risk exposures can become highly correlated, and the number of systemically important institutions can quickly escalate.

A recent example of context as a source of systemic risk is the government’s response to the failure of Bear Stearns.

In 1990, Drexel Burnham Lambert became insolvent due to activities in the junk bond market. Even though it was the fifth-largest U.S. investment bank at the time, its bankruptcy had no adverse impact on the economy. But consider what happened in March 2008, when the subprime mortgage crisis claimed its first victim in Bear Stearns. Facing severe financial instability as a result of frozen credit markets, regulators brokered a deal with JPMorgan Chase to acquire the firm rather than allowing it to fail. Had this failure not taken place in the context of financial fragility and fear, regulators would have likely allowed the firm to face the consequences of its actions through a traditional bankruptcy process.

Bird’s-Eye View

Once the sources of systemic importance are identified, regulators will be better able to understand how much potential systemic risk a firm presents to the entire financial system. Adopting this bird’s-eye view offers real benefits. To complement a microprudential supervisory approach, where regulators monitor the safety and soundness of individual institutions, a single macroprudential supervisor focuses on aggregate systemic risk for the entire financial system, helping to put the financial industry on far more stable footing.

A “tiered parity” approach to macroprudential supervision places firms within one of three tiers—highly complex, moderately complex, and noncomplex—based on the four C’s of contagion, correlation, concentration, and context. Only two of the three tiers would include firms considered to be systemically or potentially systemically important. This approach would allow regulators to focus on firms of relative systemic importance and to ensure a consistent application of regulatory taxes and supervisory oversight across each tier.

Tier 1—Highly complex financial institutions considered to be systemically important due to size or concentration and the potential risk of contagion. This tier would include both banks and nonbanks whose sheer size or concentration presents a material risk to the financial system and increases the risk of contagion. Regulators would reserve the most stringent requirements for these firms, including the highest levels of supervisory oversight and reporting requirements, regular stress tests, and mandatory requirements that encourage the markets to discipline these firms. For example, these firms might be required to issue subordinated debt, which automatically converts to common equity if capital ratios fall below a predetermined level. Tier 1 firms might also be required to participate in simulations conducted by the financial stability regulator and to ensure that executive compensation is appropriately aligned with the long-term viability of the firm and the safety and soundness of the financial system.

Tier 2—Moderately complex financial institutions considered to be systemically important due to interconnectedness, as a result of correlated risk exposures (either systemically or as part of a group) or as a result of the context presented by the economic or financial market environment. This tier would also include large financial institutions whose failure could significantly affect regional economies. Large regional banks and large insurance companies would be examples of firms included in this tier, although smaller companies might be included based on context or correlation.

Periodic stress tests, conducted to predict the response of the financial system to correlated risk or certain economic or financial market conditions, would provide regulators with guidance on how to manage the risk these firms present. Tier 2 firms would likely be subject to additional reporting requirements and more rigorous and frequent supervision than their less complex Tier 3 counterparts. Depending on the sources of potential systemic risk, they might be required to develop contingency plans to address insolvency. Other regulatory options might include portfolio limits and additional requirements for capital or loss reserves, as well as limits on exposures to counterparties, as ways to limit the potential for contagion.

Tier 3—Noncomplex financial institutions not included in the other tiers, largely consisting of community financial institutions. These firms fall outside the purview of the macroprudential supervisor due to the low probability of the threat of systemic risk. Tier 3 firms would be subject to a basic level of safety and soundness regulation and supervisory oversight. No special reporting requirements or regulatory treatments would be required.

Some details about these tiers remain to be determined:

- Will regulators identify firms as “too big to fail” (and will market watchers be able to figure out the identity of these firms on their own)?
- How much will market discipline figure into the new regulatory regime?
- Will systemically important firms increase the likelihood of moral hazard and alter the market’s perceptions about whether the government will allow those firms to fail?
- Will the market be able to identify these firms regardless of disclosure based on regulatory requirements such as debt structure, frequency of supervision, and reporting requirements?

The tiered parity approach builds on the lessons learned from the current crisis—the risk presented by systemically important institutions—and lays a foundation of macroprudential oversight that will help regulators understand and manage emerging systemic risks. In addition, it provides a balanced approach to regulatory taxes that does not unduly punish firms that are unlikely to contribute to the next crisis. ■

President’s Speech



Cleveland Fed President Sandra Pianalto introduces the concept of tiered parity in “Steps Toward a New Financial Regulatory Architecture” in an April 1, 2009, speech.

www.clevelandfed.org/For_the_Public/News_and_Media/Speeches/2009/Pianalto_20090401.cfm

Policy Discussion Paper



Read “On Systemically Important Financial Institutions and Progressive Systemic Mitigation,” Cleveland Fed Vice President James Thomson’s proposal on tiered parity.

www.clevelandfed.org/research/policydis/pdp27.cfm

Three-Tiered Proposal on the Drawing Board



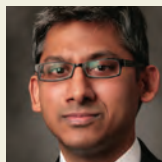
To help explain the proposal to people who aren’t policy wonks.

www.clevelandfed.org/research/topics/finstability/three_tier_risk/

The Foreclosure Timeline: The Curious Case of Cleveland's Foreclosure Rate



Timothy Dunne,
Professor of Economics,
University of Oklahoma



Guhan Venkatu,
Economist,
Federal Reserve Bank of Cleveland



The foreclosure process—from the initial filing to the sheriff's sale of the home—is expected to take about seven months in Ohio. But for a time in the Cleveland metropolitan area, it wasn't unusual for foreclosure proceedings to drag on for more than a year ... or even two. Cleveland is well known for its high foreclosure rate, but less so for its lengthy foreclosure process. Economists Tim Dunne and Guhan Venkatu thought that not enough attention was being paid to the latter, and to its importance in determining the foreclosure rate. The average time for a foreclosure episode also has implications for borrowers trying to resume payment on delinquent loans, as well as for individuals considering acquiring a new mortgage.

The Foreclosure Process

The foreclosure process has become all too familiar in Cleveland. By the early 2000s, several years before the foreclosure crisis swept across the rest of the country, the region was already reeling.

Cleveland's reputation as the epicenter of the housing crisis is known far and wide. Between 2005 and 2008, the metro area's average foreclosure rate for prime fixed-rate loans was 2.33 percent, and for subprime fixed-rate loans, it was 10.5 percent. Both of those rates were twice as high as in Cincinnati and Columbus areas during the same period, and 35 percent higher than the average in Ohio.

Economists Dunne and Venkatu wanted to understand what might be driving the differences in these rates, and approached the issue as they would approach questions about the unemployment or poverty rate. For example,

a 12 percent unemployment rate could be driven largely by high numbers of workers churning in and out of joblessness in relatively short time spans, or it could reflect a large stock of workers unable to stay employed for longer spells. The same holds true for foreclosures: A high rate might mean that large numbers of properties could be moving in and out of foreclosure very quickly, or it could mean that relatively smaller numbers of properties are trapped in foreclosure for lengthy periods.

To Dunne and Venkatu, a high foreclosure rate was one thing. But understanding why it was high would allow policymakers to target their responses effectively. After all, the appropriate policy response to foreclosures may be different in situations where there is large churning of properties in default versus large numbers of properties simply held in the process for long periods of time.

Here is what they found: From 2005 to 2008, Cleveland’s average monthly foreclosure start rate for prime fixed-rate loans, at 0.22 percent, was surprisingly close to that of Cincinnati and Columbus, at 0.17 percent. So why was the overall foreclosure rate doubly large in Cleveland? Dunne and Venkatu discovered the answer in the foreclosure transition rate, which measures the speed at which mortgages exit the foreclosure process. The lower the transition rate, the longer a mortgage slogs through the foreclosure process. In Cleveland, the transition rate for prime fixed-rate loans was 9 percent, versus about 13 percent for both Cincinnati and Columbus. Put another way, properties in Cleveland took 30 percent longer to finish the foreclosure process than their counterparts in Cincinnati and Columbus.

So Cleveland’s relatively higher foreclosure rate can be tied directly to the length of the foreclosure process there. If that process were as short as in Cincinnati, Cleveland’s foreclosure rate would drop by a third. “You’ve got to think about both of those flows [the number of mortgages entering and then exiting the process] to get a sense of what’s driving the rates,” Venkatu said.

Why Is Cleveland’s Process Longer?

Dunne and Venkatu then considered the possible reasons that the foreclosure process took longer in Cleveland. One explanation has to do with the severe economic hit Cleveland has taken in recent years. Its weaker housing

market means that properties often appreciated very little. This means that many borrowers may not have been able to pay off their lender by selling their new home (if they could find a buyer), and that they likely wouldn’t be able to refinance their existing mortgage. Loan modifications may also be less practical in a weaker housing market, because the borrowers themselves may be less equipped to shore up their credit if they have lost their jobs, and their prospects for finding a new one aren’t as great as they might be elsewhere.

All of these differences correlate with foreclosure lengths, but not as much as the variation in foreclosure statistics would suggest. Dunne and Venkatu now believe that it boils down to an administrative issue—the courts in Cuyahoga County, where Cleveland is located, were overwhelmed and underequipped with technology to process cases in a timely manner. This is evident when examining neighboring counties in the Cleveland metro area. Cuyahoga County’s foreclosure transition rate was 7.3 percent, compared with an average 12.2 percent across its four neighboring counties in the Cleveland metro area.

“We ended up with this persistent story about Cleveland, corroborated by city officials, that it’s a matter of the administrative process,” Venkatu said. “Also, the county courts enforce state foreclosure laws—that’s why we focused on counties. You see that in the outlying counties, the issue goes away.”

The Foreclosure Process

A foreclosure generally works this way (though the process differs from state to state): First, a borrower misses a mortgage payment. Within 15 days, the mortgage servicer assesses a late fee. After a month, the mortgage is reported as in default. The servicer sends several letters to the homeowner offering mitigation opportunities, and at the 90-day mark, legal foreclosure begins.

By month four, a summons and complaint are mailed to the borrower. A minimum of 90 days must elapse before a sale is held, plus a 30-day period after the sale when the borrower can still “redeem” the loan. Otherwise, the former homeowner is evicted. If nobody buys the house, it reverts to the lender, becoming a real-estate-owned (REO) property.

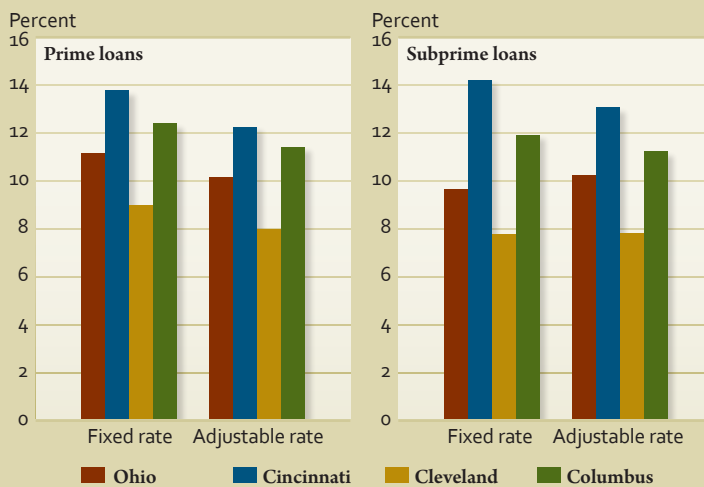


What's Normal?

What is an optimal length for the foreclosure process? Laws and procedures vary by state. The current average length is about one year between the due date of the last payment made and the sheriff's sale. Researchers with Freddie Mac put the "sweet spot" at four months—which is really closer to nine months after adding in five more months for workout efforts.¹ They note that most foreclosures associated with prime loans are mitigated early in the process, either because borrowers are able to regroup and restart payments or because lenders aggressively attempt loan modifications.

Cleveland Lags:

Average Monthly Foreclosure Transition Rate, June 2005–January 2008
The lower the transition rate, the longer the foreclosure process



Note: Rates are for metro areas.
Source: Dunne and Venkatu.

The longer the process drags on, however, the more costs mount and borrower incentives increase to continue missing payments and essentially get free rent on homes they know they will soon lose, the Freddie Mac researchers argue. Regions with longer foreclosure timelines may not be providing proper incentives for borrowers to act early with servicers on alternatives. Four months is a period "in which the borrower's incentives are aligned with both a high probability of curing out of the foreclosure and keeping the pre-foreclosure costs to the investor contained," the researchers conclude.

The likelihood of reinstating diminishes as the time in default (not necessarily the time in legal foreclosure) grows

because the people who can't reinstate right away are the people with the worst income prospects. Moreover, lenders can vary the timing of foreclosure actions to maximize the chances the borrower will be able to restart payments.

But in some instances, the borrower has already left the property, whether for lack of income or lack of interest in maintaining it. These are cases that create the opportunity for the vacant property to fall into disrepair.

Over the long term, there is evidence that regions with longer foreclosures feel the impact in the cost of credit. Lenders may actually factor in the length of the foreclosure process in pricing their mortgage terms, a Federal Reserve researcher concludes.² The upshot is that a community's very reputation for lengthier foreclosures may raise costs for all borrowers in the community.

So we are left with a complicated tangle of policy implications. A foreclosure process that is too short risks leaving behind borrowers who might otherwise be able to work out new loan terms and keep their homes. Too long, and the process provides a free ride to disinterested borrowers.

Foreclosures are also related to vacancy and abandonment. And once vacant, homes drive down neighboring property values and invite crime and further deterioration around them.

Policy Decisions

Whether to take the foreclosure process fast or slow depends on the borrower and property in question, says Lou Tisler, executive director of the nonprofit Neighborhood Housing Services of Greater Cleveland. In some instances, the owners quickly vacate their homes and the properties deteriorate. "We need to possibly speed up the foreclosure process for vacant and abandoned properties, while exhausting every available avenue for occupied homes," Tisler said. Problematically, even when borrowers might benefit from loan modifications, an increasing number of borrowers are unable to meet even the improved terms because of job losses.

Kermit Lind, a lawyer and assistant director with the Urban Development Law Clinic at Cleveland State University, says pegging the "correct" length of a foreclosure can be tricky. Many cases call for a drawn-out process, he says.

1. Cutts and Merrill.

2. Pence.

“If it’s a primary residence and occupied, from a community as well as a justice perspective, that person should have every opportunity to survive the default situation,” Lind explained. “Judges in those cases need to pay attention to the harm being done—to all affected. To ignore the impact of an abandoned property that poisons a neighborhood is counterproductive.”

Lind says he suspects a new factor is lengthening foreclosures in Cleveland—many lenders are walking away from properties after the default judgment and never filing for a sheriff’s sale. Lenders have an incentive to merely secure the foreclosure decree so they can collect on various related financial contracts. The home—which is the underlying collateral—may be the least valuable part of the deal and no longer worth maintaining. This incentive may be one reason that foreclosure starts have risen in Cuyahoga County but sheriff’s sales have not, Lind says.

Dunne and Venkatu are particularly interested in the possible correlation between lengthy foreclosures and borrowing costs. They think that when states set about writing rules for the foreclosure process, they should keep in mind the implications for borrower pocketbooks.

Reforms Make a Difference

Stephen Bucha, chief magistrate in Cuyahoga County Common Pleas Court, which oversees foreclosures, says the county’s low transition rate is now in the rearview mirror. “The county hired some new administrative employees and mowed through the backlog of cases,” he explained. “Now, it’s a six-month process.” (An exception is when loans go to a new mediation program that allows borrowers and lenders the time and means to work out new terms.) When complaints arise, they are often from people who say the process is going too fast for borrowers to keep up.

In fact, the pace of foreclosure proceedings in Cuyahoga County has caught up and in some months has surpassed the pace in other large counties like Hamilton and Franklin, Bucha says. “Now we are hitting on all cylinders,” he said.

Of course, efficiency gains in the administrative process raise a new set of issues. The relatively brisk six-month average foreclosure process may mask the ongoing mounting of foreclosure starts. “We could mistakenly conclude that the crisis has passed,” Venkatu noted.

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Interview with Matthew Kahn

JEFF ROGERS PHOTOGRAPHY

Matthew E. Kahn

Position:

Professor of Economics,
UCLA Institute of the Environment,
Department of Economics
and Department of Public Policy

Books:

*Green Cities: Urban Growth
and the Environment.* 2006.
Brookings Institution Press.

*Heroes and Cowards: The Social Face
of War,* with Dora Costa. 2009.
Princeton University Press.

Selected Papers:

"The Greenness of Cities:
Carbon Dioxide Emissions and Urban
Development," with Ed Glaeser. 2008.
NBER Working Paper #14238, under
revision for *Journal of Urban Economics*.
"Urban Growth and Climate Change."
2009. *Annual Review of Resource
Economics*. 16:1, 1-17.

Education:

University of Chicago, PhD, 1993
Hamilton College, BA, 1988

You could describe Matthew Kahn as a hybrid. Here is a University of Chicago-trained economist—as freshwater as they come—who now makes his home in saltwater territory at the University of California, Los Angeles. His field of emphasis is environmental and urban economics, and he spends much of his time explaining both the virtues and pitfalls of the green economy. Though he is the author of dozens of scholarly papers—with co-authors ranging from Harvard economist Ed Glaeser to Kahn's own wife, economist Dora Costa—he finds true joy in posting sometimes-whimsical missives to his blog.

Kahn is a professor at the UCLA Institute of the Environment, the Department of Economics, and the Department of Public Policy. He is also a research associate with the National Bureau of Economic Research. He has taught at Columbia, Tufts, Harvard, and Stanford. He earned his PhD in economics in 1993 from the University of Chicago. His 2006 book, *Green Cities: Urban Growth and the Environment*, has made him one of the nation's leading authorities on the subject. In July, the *Wall Street Journal* named Kahn's blog—"Environmental and Urban Economics" at greeneconomics.blogspot.com—one of the top 25 economics blogs. "UCLA's Matthew Kahn is a bright light among economists studying environmental and urban issues," the *Journal* said. "He has a breezy writing style that puts most other econobloggers to shame."

On October 1, 2009, Kahn visited Lexington, Kentucky, to present a paper at the Conference on Appalachia and the Legacy of the War on Poverty at the University of Kentucky. Francisca Richter, research economist in the Community Development Department of the Federal Reserve Bank of Cleveland, interviewed Kahn before the conference. An edited transcript follows.

Richter: *We will start with your work on green cities. To begin with, what types of cities would you say have boomed over the past 35 years?*

Kahn: Let me point to three big facts. In the United States, urban economists have noted—and everyone else has as well—that people seek out warm-weather cities. This is behind the boom of Phoenix, Las Vegas, and Dallas. Warm weather is one exogenous factor that people want. Second is a coastal city. Jordan Rappaport and Jeffrey Sachs have done some nice work documenting that the U.S. population wants to be on the coast rather than in “flyover” country. I was born in Chicago and I guess that’s part of the country they’re flying over. And finally, booming cities have been the *skilled* cities, those having more educated residents. Skill is usually measured by what percentage of adults are college graduates, and those cities with a lot of college graduates have greater wage growth and population growth than other cities.

Richter: *And how do so-called green cities fare? How would you even define green cities?*

Kahn: An example of a green city would be San Francisco, where a large chunk of its livability is from its climate. No government policy can get rid of humidity or cold winter temperatures. What goes right in San Francisco is that it has a feel of new urbanism, of having a walkable, outdoor life.

On local environmental criteria, San Francisco has clean air, clean water, no public health outbreaks. And then on global environmental criteria, while the United States has the largest carbon footprint per capita of any nation, San Francisco is one of our greener cities in terms of carbon dioxide per capita because people don’t use a lot of air conditioning there. The electricity they use is generated from natural gas-powered plants, which are cleaner than coal-fired plants. And people do use public transit there more than in

other cities. So to finally answer your question, a green city scores high on local and global environmental criteria. But a mayor would really only care about the local criteria in terms of pleasing his or her constituents.

That said, green cities are not a free lunch. What happens in many cases, such as in Marin County in San Francisco, with open space initiatives—you’re taking that land out of the housing supply. So from a simple supply and demand angle, you’re going to get higher home prices in these communities. That’s because the community has become more desirable and also you’re making it harder to build on this chunk of desirable land. Homeowners become richer but renters (and minority households are often renters) get punished by gentrification and may not be able to afford to live in their old community. Some urban economists are studying this churning—getting priced out of your own neighborhood. This has been documented in Harlem as crime has fallen in Manhattan.

Richter: *This leads into the question of how you measure the greenness of a city. The value of residents not imposing negative externalities on other places is a desirable characteristic you have just mentioned. A “GPI”—Genuine Progress Indicator—has also been put out as a measure of sustainability and greenness. I assume it’s not easy to measure greenness, but could you comment on that?*

Kahn: I teach environmental economics and I talk about green accounting. A nation like Saudi Arabia is wealthy per capita, but it has destroyed the whole place in mining and extracting these resources. Is it really a high-income society? The answer is no, because we haven’t netted out the destruction, the depreciation of natural capital, and the health damage done in the production of that income. The challenge with this GPI is that it’s a great idea in theory, but how do you operationalize it?

Economists for decades have debated this. Joseph Stiglitz released a report saying national income accounting is incomplete [because environmental effects are not recognized] but you say, OK, Nobel Laureate Stiglitz, what should we do? The report didn’t give an answer.

So let’s see if I can quickly sketch an answer. Let’s do greenhouse gas emissions because it’s easier. Nicholas Stern of the London School of Economics, Lord Stern, has been raising interest in the issue of climate change. He has argued that every ton of carbon dioxide we release causes roughly \$40 of social damage to the world. Suppose that’s true. In that case we can do the GPI calculation—if a factory in Cleveland produces \$1 million of output but also creates 50 tons of carbon dioxide, Lord Stern would say that factory’s value-added to the world economy is that \$1 million of production minus the \$40 per ton times the 50 tons. We need to net off the pollution damage but we have to be macho enough, if I could use that word, to estimate these damages. The hard part is figuring out for every extra unit of air pollution or ton of carbon dioxide, how much damage has been created.

I’m more optimistic that we can do this type of calculation for greenhouse gases than for local pollutants. Let me tell you about the challenge with air pollution. Suppose a factory in Cleveland produces some output, perhaps Twinkies, but it also produces air pollution. As an economist, if you said to me, Matt, what is the total value-added of this factory? I will of course say we need to net off pollution damages. But how are we going to do that? I would need to talk to an atmospheric chemist about how many people live near that factory. Not everybody in Cleveland will be affected by that factory. If the wind blows east, it’s only the people who live to the east of the factory will be affected.

Then we get into the next question: Who are those individuals? Are they old and asthmatic, or are they young supermen, a bunch of LeBron Jameses who can take air pollution without any damage? A bunch of LeBron Jameses can be exposed to the Twinkie factory and not suffer at all, whereas a bunch of elderly people might all die. The public health costs of the pollution would be huge, so determining the GPI indicator for measuring the environmental impact of that factory in Cleveland would require a huge amount of data. Unfortunately I think it has to be done on a case-by-case basis. Harvard researchers have estimated the social damage caused by coal-fired power plants, where they calculate how many people live near these plants and who they are in terms of their demographics and how much they are likely to suffer from the power plant's pollution.

On demographics in many major cities: What we are seeing are highly educated young people who are not yet married, without children, wanting to live downtown and people like my parents, who after their suburban days want the hipness of downtown.



Richter: This gets to the relationship between greener standards and the economic development of cities: As cities grow, they affect the environment. At earlier stages of development, the economic growth of cities could contribute to environmental degradation.

Kahn: Let me tell you a story about Los Angeles, my new home. In the 1950s, people in L.A. started to drive more and more. There were more and more people in L.A., with more and more money, driving more and more miles, but the cars did not have catalytic converters. In the United States, we only began to phase in catalytic converters starting in 1972. What an economist would say is the scale of the economic activity increased—

more and more people driving more and more cars more and more miles, and emissions per mile did not decline and this led to the horrible smog problems that Los Angeles is famous for, the orange city.

What you're referring to is an environmental Kuznets Curve. With economic development, many urban, environmental problems first get worse and then get better. In 1972 when I was six years old, I was not in L.A., but I can imagine the city was getting richer and it was choking on the pollution. Middle-class people must have said, what the heck is going on? This is not a green city. We are in the United States. Can't we do better?

Starting in 1972, there was a regime break. California got tough on demanding that emissions of driving per mile get much lower, and by the 1980s and the 1990s, smog got much better in L.A. Emissions per mile of driving were falling faster, even though the total number of miles driven was rising. More people, richer people, were driving more, but emissions per mile fell, because of the technological advance of the catalytic converter—technology offset the consumption.

Many environmentalists point to the quantity effect of capitalism, the American Dream that people want more, more, more. But people ignore the quality effect that a richer nation can have higher-quality [i.e., cleaner] products. In a nutshell, it's a race between quantity and quality that generates this inverted U with economic development—first you get pollution, but then you actually solve pollution problems with further economic development.

Richter: How would you respond to the concerns of poorer cities—they are at the first stage of development and dealing with issues of low incomes, stressed budgets, crime, under-performing schools. Are there still ways for them to pursue some green policies?

Kahn: I think this is a crucial question for cities. Your question is both about local public finance and about green cities. Let me tell you an optimistic

story. Imagine a city that, because of its ability to be green, its ability to overcome its crime problem, young urbanites feel safe downtown and want to live and work downtown. They will pay their taxes grudgingly, and the mayor will use a fair chunk of those taxes to redistribute to the urban poor in the same city. So there can be a win-win. A mayor whose focus is perhaps urban minorities might actually want to create a green city to create a revenue base in order to redistribute to constituents who he's worried about.

I believe that story. I think there is some evidence for that story. On demographics in many major cities: What we are seeing are highly educated young people who are not yet married, without children, wanting to live downtown and people like my parents, who after their suburban days want the hipness of downtown. Both of those demographic groups are living in the center city, and this creates a tax revenue source off the sales tax base and the income tax base for a center city mayor. I agree the mayor has problems. Schools have issues. There are still large pockets of urban poverty. But one way to address these issues is to build this golden goose, this tax revenue off the green, livable city, and then to engage in redistribution that the society needs.

Richter: On your blog, you noted that you can buy 100 homes in Detroit for the price of one in Westwood [where UCLA is located]. Is that a good deal?

Kahn: I started this blog because my wife wanted me to stop telling her all my ideas, and this was a cheap way to communicate with all my friends in academia. Many of them read it and then send me rude remarks. But to your question, UCLA has been suffering from high local real estate prices! A sign to economists of great quality of life is high real estate prices, but UCLA is having trouble recruiting faculty because of it. Faculty at an Ohio State or a university in Boston say, "UCLA is a great school, but I can't afford the housing nearby." I'm talking about a \$1.3 million, 2,000 square

foot house, not the Playboy mansion, that is affecting the ability of UCLA to recruit.

Then I read another webpage that Detroit homes are \$13,000 each. So my thinking was along these lines: I'm writing a new book about how climate change will affect cities' quality of life. For example, if winter becomes warmer in Cleveland and Detroit and other Midwest and Northeast cities, then by the year 2075 the current huge home price differential between Los Angeles and these cities could sharply shrink. If these cities become warmer, will Cleveland and Detroit by the year 2075 be much more desirable places? A good economist should react to that news before it is reflected in prices. So I should be selling my Westwood house and making this purchase now.

But when people commented on my piece they pointed out that most of these Detroit homes have been stripped down, no metal. You would have to invest a huge amount of money to make these livable homes. While you can buy a Detroit home for \$13,000, you cannot move into it.

Richter: *Cities with greater skills experience greater growth. So with regards to Appalachia, should efforts in this region be focused on retaining recent graduates, or on recruiting them?*

Kahn: This is an excellent and very important question. Appalachia could increase its stock of skilled people in two ways. First, if they can grow their own, such as young people who go to Appalachian State University and after graduation stay. Second, if someone goes to UCLA in Los Angeles and says to heck with this and moves to Appalachia.

But in truth, when I looked at the data, nobody outside of Appalachia who is highly skilled is moving to the region. In my opinion, Appalachia's best chance to raise its skill level is to grow its own and then get aggressive in retaining them. It's like a baseball team with a minor league farm system for growing new stars and then doesn't lose them to free agency.

If I were a mayor or governor in the states that comprise Appalachia, I think I would talk more to the 22-year-olds finishing Appalachian State University and West Virginia University, and ask them—are you staying? If they are going, what was the factor that pushed them out? Was it jobs? Was it that it's boring here? And then use the clues from that survey to design a set of policies to encourage them to stay. The challenges Appalachian cities face are: They are relatively small, not on the coast, many have cold winters, and the economy is undiversified. They have manufacturing and mining but not much "Google" activity.

So if a computer science major at Appalachian State wanted to stay in the region, what are the set of jobs he could get right now? That's the question I'd like to ask the governor. Those are the fights the governor needs to win to increase the skill base of the region.

Richter: *Small cities are often characterized by very little economic diversification. How can cities achieve economic development in that context?*

Kahn: The oldest question in urban economics is the chicken and egg riddle: Do people follow jobs or do jobs follow people? One strategy is what Berkeley and MIT economists documented with the "million dollar plant." Enrico Moretti and Michael Greenstone have documented that rural counties that successfully recruit big manufacturing plants, like a new car factory, offer direct economic opportunities by creating new jobs and stimulating increased demand by other firms in the same county. For example, if a new car manufacturer opens, an input supplier who makes tires might locate nearby to supply these tires.

There are two different paths for achieving economic development. You can use incentives to attract new jobs to the region and hope that this attracts young people, or you can attract skilled people and if word gets

out that there is a high-quality-of-life place where the skilled want to live, then employers who want to hire them will show up. My advice for Appalachia's politicians is that they should experiment and try out both strategies.



In my opinion, Appalachia's best chance to raise its skill level is to grow its own and then get aggressive in retaining them.

I'm an honest man. I think it's important to know what you don't know. When you know that you don't know something, the answer is to experiment! Too often in the past, development economists have told poor nations do this, do that—where I think this is a case where we want to experiment and see what works using a field experiment approach.

We have evidence that poverty is declining in communities and that per capita income and employment are rising in cities and areas that are trying these various treatments, whether it is subsidizing college graduates who remain in the region or subsidizing million-dollar plants to move into a county. The key issue here is having a well-defined "control group" to determine what local poverty rates would have been if the specific policy being evaluated had not been tried.

Richter: *Pittsburgh was built as a manufacturing hub and now has transformed itself into something quite different, in fact becoming a recent economic development success story. What lessons can a city such as Cleveland learn from Pittsburgh?*

Kahn: One special thing about Pittsburgh is that both Carnegie Mellon University and the University of Pittsburgh are downtown. But I would hope that Cleveland could follow a very similar arc. I actually want to hear your views on that. I see no reason why Cleveland couldn't have the same success unless we're talking about Super Bowls!

For economic growth, you can either retain your own or attract others to move in, but you can only attract others if they have a generally favorable assessment of the city.



Richter: *Cleveland is a small-enough city that it allows one to go from one place to the next in a short period of time. Enough culture, wonderful music with the Cleveland Orchestra....*

Kahn: The United States has over 200 metro areas, and it would interest me to learn about perceptions about Cleveland for people who live in other cities. If we asked people in Orlando what they think about Cleveland, putting LeBron James aside, what would they say? Would they say it's the "mistake by the lake," or talk about the water catching on fire in 1969? If I were the Cleveland Chamber of Commerce, I think it would be worth commissioning a study to see if there's a fundamental disconnect in perceptions. Should they be buying everyone a ticket to visit Cleveland? Tourism brings people in from Kansas and allows them to experience New York, and some of those folks move in!

For economic growth, you can either retain your own or attract others to move in, but you can only attract others if they have a generally favorable assessment of the city.

Richter: *In three generations, will Americans be worse off? Specifically, I wonder about small towns in Kentucky, or about Cleveland.*

Kahn: I'm a big-time optimist. Economic growth will continue because we have the world's best universities. My own research focuses on "smaller" quality-of-life issues. I hope we can get a handle on traffic congestion. Economists have proposed road pricing, like what London did with its congestion charge. But no one is listening to us.

In terms of crime in cities, we've made great progress. Air pollution? We've made great progress. Water pollution in cities? My father now goes fishing on the Hudson River, which was disgusting 30 years ago, and he's catching fish! There are people canoeing and jogging near the river. On several dimensions we've reclaimed pieces of our cities. But I do worry about climate change in our cities, in particular how that will affect our coastal cities. But, I'm highly optimistic about our long-run quality of life.

In terms of small cities in Appalachia, I think they will find their niche. They certainly have the right incentives to do so. One question I have been asking is about the future of coal in Appalachia. When coal prices have been high, Appalachia has been doing great. But in a world of carbon pricing, as coal-based electric utilities substitute away from coal, that whole industry might collapse, which will have huge short-run costs for Appalachia. But as a green cities guy, I would argue there are long-run benefits.

Richter: *Along those lines, some people, including members of the current Administration, view climate change as an opportunity for innovation and job creation. Do you agree with that assessment?*

Kahn: I hope so, but it takes an incentive. Ninety-nine percent of economists agree that we need a carbon tax or some sort of cap-and-trade system to put a price on releasing carbon-greenhouse gas emissions. That would create all sorts of new opportunities.

This hotel we're in right now, how energy efficient is it? And if this hotel faced a carbon tax, it would have the right incentives to hire a weatherizer to take a new look at this building to see if it could use energy more efficiently. That's the type of job that would be created. Some jobs would be destroyed, such as very energy-intensive manufacturing. Certain steel activity uses a high amount of electricity. If we have coal pricing,

electricity prices will go up and some of this activity will migrate abroad. I think we need to have an honest discussion about job creation and job destruction once we introduce this carbon legislation.

Richter: *Why did you become an economist? Did you know since you were three years old that you wanted to become an economist?*

Kahn: My father had me reading the *New York Times* from an early age. I was looking for a subject that would help me think about the real world. Now, this deep recession has been a little humbling for economists. It has caused a lot of debate at lunch at UCLA! But I find on average that microeconomics is a powerful tool for understanding the world.

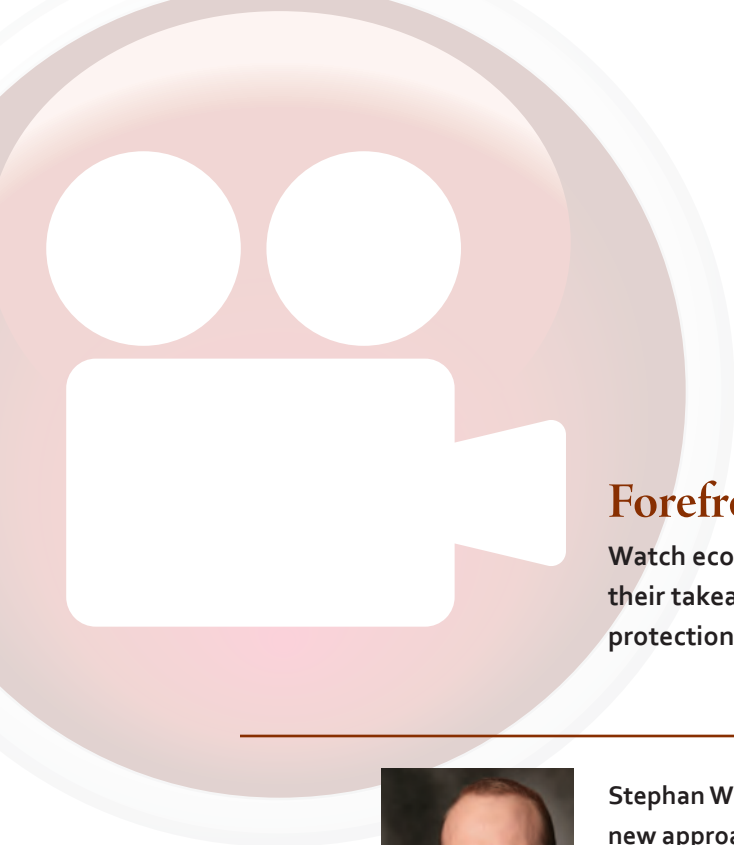
I can't claim to be an activist. I would love people to say that Kahn was good at understanding this transition of cities from areas that focused on industrial activity to consumer cities, where people get to play and live out their lives in a high-quality-of-life setting. To answer your question, economics, both incentive theory and the statistics that we're taught, has been a powerful tool for helping me understand the dynamics of city quality of life.

Richter: *Thank you very much.* ■



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Forefront Roundtable

Watch economists with the Federal Reserve Bank of Cleveland discuss their takeaways from the September 11, 2009, seminar on consumer protection at www.clevelandfed.org/forefront.



Stephan Whitaker on the need for new approaches to consumer protection:

The recent crisis has revealed a couple of major gaps in consumer protections. One of them is that a lot of consumer protections in the past focused on access. We were really concerned about making sure that people could get consumer credit if they needed it, or get mortgages. And there wasn't so much attention paid to making sure that they didn't get into a product that would cause them a financial hardship in a matter of months or years. So now we need to rethink what we're doing and adjust it for the new realities.



Daniel Littman on the search for consumer protection tools beyond disclosures:

A mixture of tools probably needs to be used because disclosures aren't enough to keep people from products that are not suitable for them or products offered to them involving fraud. There probably needs to be some mixture of compulsion that keeps certain kinds of products off the market or that targets products to the right kinds of people—along with better disclosures.



Thomas Fitzpatrick on the challenge of improving disclosures in mortgage contracts:

I think there's a lot of room for improvement there. It's commonly said that disclosures are written by lawyers for lawyers. And as a lawyer, I can tell you that they're really not written for us, either. They're very, very complicated.

View: Can Foreclosures Be a Neighborhood's Best Friend?



Mary Helen Petrus,
Community Development
Manager

Rampant foreclosures present a dichotomy for communities. On the one hand, foreclosure can deal a crushing blow to the American Dream of homeownership, and it certainly can accelerate the decline of neighborhoods. But often overlooked is the other hand: Foreclosure can sometimes serve as a useful tool to stave off community blight. Using the proper legal tools, older industrial cities can use foreclosure to acquire property that otherwise would become vacant or abandoned. As a result, crisis can be transformed into opportunity—the rare opportunity to rethink redevelopment and land use.



Mark Wiseman, attorney and former director of the Foreclosure Prevention Program in Ohio's Cuyahoga County, once described the foreclosure process as akin to cutting sacks of sand from an air balloon's gondola. These sacks are the debt and title disputes weighing down the property. As they are severed, the property is unleashed. Wiseman argues that communities need to get organized about setting more of these balloons free—and they can do it with foreclosure.

I am not talking about forcing people from their homes. I am talking about homes that have been long abandoned, or that are very likely to become abandoned, and are stuck in legal limbo. Consider what happens in a so-called “toxic title” situation. First, the homeowner leaves the property as soon as the lender starts the foreclosure process. Then, as the property deteriorates from lack of care, the lender halts foreclosure proceedings because the underlying home has lost so much value that it's not worth pursuing the action. In the end, government officials have a difficult time figuring out who should be held accountable—the absent homeowner or the disinterested lender. Even in cases when homeowners want to surrender their property, they often can't do so because of title complications. If enough properties get locked in toxic-title limbo, entire neighborhoods can quickly fall into disrepair.

The fact is, foreclosure in many cases is the only tool that communities have at their disposal to reclaim and reuse abandoned property. Tax foreclosure—that is, when governments launch the foreclosure process because a property is delinquent on taxes—is a particularly useful tool. It has been endorsed by the City of Buffalo and the National Vacant Properties Campaign as a way for land banks to acquire vacant and abandoned properties that are saddled with unpaid liens.



Foreclosures of unoccupied property can help clear the way for something weak-market cities need more than homes: safe, open space.

But foreclosure is far from a perfect tool for clearing title. As the housing crisis has unfolded, public perception about the personal tragedies associated with foreclosure has tended to sway legislators to impose restrictions on the process. The danger with this perception is that we risk losing sight of foreclosure's relationship to property acquisition and reuse.

The stigma of being associated in any way with encouraging foreclosure, which many envision strictly as efforts to remove people from their homes, understandably makes neighborhood development groups skittish. Even so, when houses are vacant and abandoned, foreclosure is the most straightforward way to clear title. What is really more controversial—using foreclosure in an effort to save neighborhoods, or watching vacant homes topple others nearby like dominos?

Policy Implications

To be clear, in viable neighborhoods, the focus ought to be on improving the quality and affordability of housing for the people who still live there. This could be done by rehabbing homes and improving rental housing stock and supply.

For nonviable neighborhoods, a completely different prescription is needed. The key is to create better legal tools to clear title—ways that do not depend on the self-interest and timing of debt collectors. Among them:

- Quiet title actions, in which governments go to court to “quiet” any and all other claims to a property's title
- Laws to facilitate nuisance abatement through receivership, in which courts can assign an overseer to repair or improve vacant properties
- New rules making it easier for willing homeowners to forfeit their properties so that governments can take stewardship
- Processes for tax foreclosures that don't have to go through the courts

All of these methods should be further explored. In the meantime, instead of waiting until all collateral value is lost on foreclosed properties, communities should enforce housing codes more rigorously, make mortgagees responsible for the condition of abandoned property, and regulate property transfers when properties have serious code infractions on record. Of course, these strategies can be difficult for cash-strapped communities to achieve in practice. We in Cleveland are all too familiar with the painful and expensive process of trying to locate title holders to hold them accountable.

The rewards can be worth the struggles, however. Foreclosures of unoccupied property can help clear the way for something weak-market cities need more than homes: safe, open space. Too many homes now in foreclosure should be demolished because of obsolescence or profound disrepair. Communities and policymakers should explore ways to facilitate demolition through adequate funding mechanisms. Moreover, it's time to discard the old operating assumption of “if we build it, they will come.”

Our challenge—and perhaps the silver lining in the foreclosure crisis for the Fourth Federal Reserve District—is making the leap from a traditional community development model to one featuring sustainable redevelopment designed to promote truly viable neighborhoods. These are the essential ingredients of healthy communities in weak-market regions. ■

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