Mitigating the “Scalability of Bad Practices” in Consumer Finance

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CONSUMER PRODUCT REGULATION IS AT THE CORE OF EFFECTIVE FINANCIAL REGULATORY REFORM

At the core:
Atomized, arm's length private sector transactions

Positive risk bias
Management
Positive risk bias
Consumers
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Equity Markets
discipline management risk-taking
(Boards of Directors)
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- At the core: Atomized, arm’s length private sector transactions
- Management: Positive risk bias
- Consumers: Positive risk bias
- Equity Markets: discipline management risk-taking (Boards of Directors)
- Debt Markets: discipline Boards’ risk-taking (Rating Agencies)
CONSUMER PRODUCT REGULATION IS AT THE CORE OF EFFECTIVE FINANCIAL REGULATORY REFORM
REGULATING CONSUMER FINANCE IS HARD BECAUSE OF “THE SCALABILITY OF BAD PRACTICES”
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  - Bad for consumers
    • The “grandmother” test
    • Transparency, fairness, suitability
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Information Asymmetry
INFORMATION ASYMMETRY HELPS BAD PRODUCTS TO CROWD OUT GOOD ONES

Example
("traditional" bank loan)
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- Small business
- Community bank

Example ("traditional" bank loan)
INFORMATION ASYMMETRY HELPS BAD PRODUCTS TO CROWD OUT GOOD ONES

- **SALES**
  - **CUSTOMER**
    - Small business
    - Home buyer
  - **Salesperson**
    - Mortgage broker
    - Bank
  - **Underwriting**
    - Community bank
  - **Servicing**
    - Third-party servicer
  - **Funding**
    - ABS markets
    - CDO markets

Example ("traditional" bank loan)
- Small business
- Community bank
- Bank
- Third-party servicer
- ABS markets
- CDO markets

Example (ABS-funded option-ARMs)
- Home buyer
- Mortgage broker
- Bank
- Third-party servicer
- ABS markets
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Asymmetry #1
Broker’s Information Advantage vs Consumer
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**Asymmetry #1**
Broker's Information Advantage vs Consumer

- Result: Consumers...
  - Overestimate own credit-worthiness
  - Underestimate all-in cost and risk
  - Borrow and pay more than they otherwise would
  - Systematically favor teaser rates, gimmicks

  › **Bad product drives out good**

- New approach: “LA Restaurant Grades”
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**Asymmetry #2**  
Risk Seller's Information Advantage vs Buyer

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**Example**  
(“traditional” bank loan)

- Small business

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**Example**  
(ABS-funded option-ARMs)

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Asymmetry #2
Risk Seller's Information Advantage vs Buyer

- Result:
  - Dubious loans get funded
  - Breakdown in feedback loop from credit performance to origination standards
  - Originate-to-sell-garbage less capital intensive than originate-to-hold-quality
    › Bad product drives out good

- New approach: Risk Retention Requirements
NEW RISK RETENTION REQUIREMENTS SHOULD BE IMPLEMENTED ON TWO DIMENSIONS

Potential Risk Retention Framework and Examples

- Twin objectives:
  - Prevent breakdown of performance-to-origination feedback loop . . . but
  - Preserve liquidity throughout capital structure

- Not all products & channels are created equal

- Not all market-driven structures were broken (e.g. credit card residuals)
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Seller’s influence on the value of the loan

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Potential Risk Retention Framework and Examples

- **High**
  - Credit card receivables

- **Medium**
  - Dealer-originated auto loans

- **Low**

Seller’s influence on the value of the loan

Difficulty for markets to diligence

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Potential Risk Retention Framework and Examples

- **High**
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- **Medium**
  - Dealer-originated auto loans

- **Low**
  - Whole-loan sales of bank-originated CRE

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