

Consumer financial protection: advantages, dangers and should it be a new agency?

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Summary

Widespread consumer credit defaults help make it clear that improved consumer protection is needed. Had there been better protection prior to the financial crisis this would have ameliorated the severity of the crisis and might even have forestalled it.

However, there are dangers in a CFPA, dangers of over regulation and of stifling innovation. Proposals for blanket prohibitions and for compulsory provision of plain vanilla products are probably a step too far. The emphasis should be on improved transparency and on solving the market failure of inadequate information.

Many consumers lack knowledge and understanding in the financial area, so that disclosure alone is unlikely to be enough to solve the market failures in some areas. Even if it avoids ex ante prohibitions, the consumer protection agency should look for situations where companies are exploiting the lack of consumer knowledge. They should stop sharp practices and perhaps exact penalties on companies that have used them.

As a first choice, the U.S. should have a single conduct of business regulator protecting both small shareholders and consumers of financial products. The SEC is the natural choice to be the conduct of business regulator and the home for a consumer financial protection agency. As a second choice, a separate agency could serve, provided it has the appropriate structure and a staff that is balanced and knowledgeable about markets. This short paper makes these points by identifying key structural provisions of the Treasury's proposed CFPA, enumerating some concerns that have been raised about it, arguing for a more balanced perspective on consumer protection, and offering some recommendations.

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Introduction

One important cause of the financial crisis was the housing bubble: individuals and families borrowed heavily to buy houses they could not afford and subsequently defaulted on their mortgages. There was also speculation in the housing market as people bought residential properties hoping to sell them at a profit. And families that already owned homes borrowed against the equity that they had built up and then were unable to meet their debt obligations. This latter problem became much worse as a result of the subsequent decline in home prices and the loss of household income in the recession.

Difficulties in meeting credit card payments have also contributed to the financial crisis. A source of these problems arose when some credit card companies engaged in sharp practices. For example, some companies changed the due date for payment without warning, so that customers missed a payment deadline and incurred fees or penalties, including perhaps a sharp upward adjustment of the interest rate on outstanding balances.

In response to these experiences, it is appropriate to seek out policies to make sure that the same thing does not happen over again. Any future financial crisis will likely be different from the one we are going through, but it is still important to learn the lesson of history and not repeat it. Reasonably, therefore, the Obama administration has made consumer protection a major facet of its financial regulatory reform plan, proposing a new agency, the Consumer Financial Protection Agency (CFPA) as one of its reform proposals.

In the Senate, the Chair of the Banking Committee, Christopher Dodd has expressed support for measures to provide greater consumer protection. Barney Frank, chair of the House Financial Services Committee, sponsored a version of the CFPA, named the “Consumer Financial Protection Act of 2009”, or HR 3126. While major facets of the bill are quite similar to the administration’s proposal, a major difference between the House bill and the Obama plan is that the House bill “preserves the current federal banking regulators’ role to enforce the Community Reinvestment Act (CRA).”² It should be noted, however, that at the time of the writing of this paper Chairman Frank is circulating a new version

² http://www.house.gov/apps/list/press/financialsvcs_dem/press_070809.shtml

of the bill that may in part exempt nonfinancial businesses that are acting in their traditional capacity, as well as other modifications.³ Similarly, in testimony before the House Financial Services Committee on September 23, Secretary Geithner expressed a willingness to work with congressional and industry opponents to soften some of the part of the proposal these stakeholders deemed most objectionable.⁴

Still, the stated rationale for this proposal certainly raises the question of whether or not the best way to protect consumers and to protect taxpayers from the consequences of widespread consumer credit defaults is to create a new consumer protection agency. This short paper will identify key structural provisions of the Treasury's proposed CFPA, enumerate some concerns that have been raised about it, argue for a more balanced perspective on consumer protection, and offer some recommendations.

Key structural provisions of the Treasury's proposed CFPA

The Treasury CFPA plan would cover all consumer financial products, regardless of the identity of the seller. For example, it would have jurisdiction over all mortgage products, whether they are sold by a depository bank, mortgage broker, state or federally-chartered bank, etc. While the proposed CFPA will consult and coordinate with the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC)⁵, they will retain authority over their current regulatory domains of investor protection.⁶

Second, the CFPA would have sole authority to interpret and enforce existing consumer financial protection laws, such as the Truth in Lending Act (TILA), Home Ownership and Equity Protection Act (HOEPA), and others, but at the same time, it would be granted broad authority to "fill in the gaps" of such laws and adapt newer regulation and protection.

³ Silla Brush, "Rep. Frank tweaks consumer financial agency legislation," The Hill, September 22, 2009.

⁴ Kevin Drawbaugh, Geithner urges consumer watchdog," Reuters, September 23, 2009. Available at: <http://www.reuters.com/article/politicsNews/idUSTRE58M3SL20090923>

⁵ CFPA Act §1016 (a)

⁶ CFPA Act §1022(f) (2) (a), pg 24, CFPA Act §1022(f) (3) (a), pg 25

Third, the CFPA would be authorized to require that all disclosures and other communications with consumers be reasonable: balanced in their presentation of benefits, and clear and conspicuous in their identification of costs, penalties, and risks.

Concerns that have been raised about the Treasury CFPA proposal

While there has been support for the CFPA from various circles, it has also come under a large amount of criticism, and as previously noted is one of the most hotly-contested parts of the administration's regulatory reform proposal.

There has been vehement opposition to the CFPA from various industry groups who argue that the agency would wield power without adequate checks and balances.⁷ Others are concerned that it will increase the cost of credit while decreasing the availability of credit and stifle financial innovation. Still others feel the agency would be another example of big government authority, choosing what products are considered "safe" for consumers and trumping individual choice. As has been widely reported, the CFPA would be authorized to require that every mortgage lender offer "plain vanilla" mortgages along with more sophisticated, risky ones. It may be required to present these to the consumer first, or consumers may have to "opt-out" of the plain vanilla mortgages. Many industry participants contend that this will be harmful to competition and financial innovation

In this crisis, many innovative mortgages got a bad name because they resulted in foreclosures, but a lot of the problem was that house prices fell. If house prices had continued to rise, as almost everyone expected, some of the innovative mortgages would have helped lower income families to buy homes and improve their living standards.

The Treasury proposal states that, "Consumers should verify their ability to understand and use disclosure forms with qualitative and statistical tests."⁸ And Peter Wallison, from the American

⁷ As previously noted, both Chairman Frank and Secretary Geithner have expressed a willingness to modify some of the proposals, including "plain vanilla."

⁸ The US Department of the Treasury, "Financial Regulatory Reform – A New Foundation", June 2009, pg 63.

Enterprise Institute and my co-chair on the Pew Task Force, interprets this to mean that potential borrowers would be forced to take tests to measure their aptitude and intelligence.⁹

The proposal also directs that “The CFPB could determine that prepayment penalties [or anything else] should be banned for certain types of products, such as subprime or nontraditional mortgages, or for all products, because the penalties make loans too complex for the least sophisticated consumers or those least able to shop effectively”¹⁰ The financial industry is concerned that this gives the CFPB too much power to ban whatever it sees fit. And another concern to the financial industry is that the Treasury White Paper does not propose that the CFPB regulations would pre-empt state regulators. The industry argues that this suggests an open invitation to states to pile additional restrictions on top of the Federal legislation.

Some financial experts (especially from overseas) have made the argument that a major reason for the crisis in the US was that mortgages in most states are non-recourse loans. That may encourage people to walk away from their homes when they are under water—mail in the keys—knowing that they do not face the possibility of court action to come after the bank’s losses. A case in point is Joel Stein’s recent Time Magazine piece profiling house “short selling” in Las Vegas.¹¹ Clearly there were unscrupulous brokers that persuaded families to take on mortgages they could not afford. And yet, at the same time, there were speculators and households that lied on their application forms, manipulated their credit scores or concealed financial problems. There is a danger in having rules that may seem to give consumers protection but that encourage irresponsible behavior that ultimately raises the costs for everyone.

⁹ Peter J. Wallison, “Elitist Protection Consumers Don’t Need,” *The Washington Post*, July 13, 2009.
<http://www.washingtonpost.com/wp-dyn/content/article/2009/07/12/AR2009071201663.html>

¹⁰ compete cite} The US Department of the Treasury, “Financial Regulatory Reform – A New Foundation”, June 2009, pg 68

¹¹ The article describes cases of homeowners in situations where they owed more on their home than the home was worth. They had economic incentives to buy a similar home for a greatly reduced price and cease paying the mortgage on the original house that they owned. According to the article, the banks are willing to “let the owner sell the house at a huge loss rather than drag[g]ing everyone through foreclosure.” Joel Stein, “Las Vegas: The Casino Town Bets on a Comeback,” *Time*, August 14, 2009.
<http://www.time.com/time/nation/article/0,8599,1915962,00.html>

Towards a Balanced Perspective on Consumer Protection

In an assessment of the CFPB proposals¹², Doug Elliott of Brookings argued that the administration does a good deal to allay the fears that the new agency would stifle innovation, including: the overall focus on unfair, deceptive, and dangerous practices, rather than risk, per se; the instruction to weigh economic costs and benefits; the instruction to place a significant value on access to financial products by traditionally underserved consumers; the prohibition against establishing usury limits and; the option to consider previous practice in regard to financial products. In short, some of the criticisms of the Treasury plan seem over the top. Treasury recognizes the dangers of having an agency that can over-regulate and damage the market and its proposed structure would avoid that possibility. It is also somewhat disingenuous for the financial sector to scream quite so loudly at the proposed new regulations, given that this sector has helped drive the economy off a cliff. Something needs to be done to provide better protection. Markets failed and the existing structure of regulation did not stop the erosion of mortgage lending standards and other undesirable practices.

Given that something must be done, what are some of the do's and don'ts for consumer protection?

- The “plain vanilla” requirement needs clarification and cautious application. It is a good idea that all borrowers know that fixed rate 30-year mortgages are available and all mortgage lenders should be required to tell borrowers about this option. That does not mean all lenders must provide such products themselves, nor does it mean that all borrowers will be better off with such a mortgage.
- The proposed regulations would not in practice force potential borrowers to take humiliating tests before they can take out a loan. The purpose of regulation in this area is to make sure that lenders do not target customers that lack good understanding of financial products and then persuade them to take on risky loans. The enforcement would be on the lenders not the borrowers.

¹² http://www.brookings.edu/papers/2009/0701_cfpb_elliott.aspx

- Treasury says that simple standardized forms would be provided to borrowers that showed the amount of payments they can expect to pay over the life of the loan and how those payments might be affected by future changes in economic conditions, primarily changes in interest rates. Credit card holders must be informed (and not just in the fine print) if their rates can be changed. These are good ideas and eminently feasible.
- The Treasury plan contains a lot of wording about prohibiting certain practices and products. Such prohibitions should be minimized, and replaced by clear disclosure provisions. The protection agency should have the power to penalize companies that use deceptive practices to take advantage of customers that lack knowledge or understanding of financial products. But regulations that are replete with prohibitions on different products will tend to discourage innovation. A product that is dangerous to one customer may be very helpful to another customer.
- Disclosure is part of a broader issue. There is no question that the financial crisis was caused or at least exacerbated by the market failure of “asymmetric information”. Lenders knew more than borrowers, or sometimes vice versa. Protection rules should try to rectify these asymmetries on both sides, requiring clear disclosure by lenders and penalizing borrowers who lie about their financial situations. The agency should be balanced.
- The protection agency must not become a magnet for activists that do not understand the workings of markets. We do not want Michael Moore economics. Uninformed populism results in bad policymaking. There are similar activists in the financial protection area that are essentially proposing the socialization of markets or, at the least, do not understand how excessive regulation could end up hurting consumers.
- The protection agency should be able to work with prudential regulators to gain access to relevant information. If a particular line of business shows very high profit levels, it should be possible to determine whether this is because it is a real and valuable innovation or whether it is exploiting consumers.

Where should consumer financial protection be located?

The Treasury plan suggests that consumer protection needs a separate new agency. In the past, consumer protection has been part of the prudential supervision process, at the FED or other regulatory agencies. That has clearly not worked very well. The FED did not police mortgage lending effectively prior to the crisis. There were issues around the authority that the FED possessed, but certainly they knew about the erosion of mortgage standards in state chartered financial institutions and elsewhere and they did not respond. It would have been helpful had the FED brought all mortgage regulators to Washington, dressed them down and told them to stop the bad practices. The crisis would have been much milder, but unfortunately this did not happen. The argument for a new agency is that consumer protection will always be the poor relation inside a prudential organization.¹³ Today the FED and other regulators are very focused on consumer protection, but the danger is that situation would fade over time. The case for having the CFPA separate from prudential regulation is a good one. So that leaves only the question of whether it should be part of another agency or a free standing agency.

Part of another agency

There are candidates for existing agencies that could house the CFPA function. The FTC is a possibility, but perhaps the best candidate is the SEC. The SEC did a terrible job of supervision over broker dealers. They gave Bear Stearns a clean bill of health shortly before the company went under. But Mary Schapiro, the new head, has a strong track record and her promises to revitalize and reform the agency should be taken seriously.

Why the SEC? In looking around the world at how different countries manage their financial sectors, we have been impressed by the so-called “twin peaks” approach, used for example by Australia.¹⁴ With the twin peaks system there are two regulators, the prudential regulator and the conduct of business regulator, with the latter charged with the protection of small and minority shareholders and with

¹³ For more discussion see Adam Levitin, “Consumer Financial Protection Agency,” Pew Financial Reform Project Briefing Paper #3.

¹⁴ For more discussion see, Adriane fresh and Martin Neil Baily, “What does international experience tell us about regulatory consolidation?” Pew Financial Reform Project Briefing Paper #6.

consumer protection. Together with the central bank, these two regulators make up a tripartite group that should be required to work closely together to improve the safety, stability and efficiency of the financial sector. Unlike the current US system, this model has only a few separate regulators, each of which has considerable power, each of which should be given the power to pay well and expect accountability from its employees. There is no guarantee that streamlining the number of regulators would avoid another crisis, but both common sense and the experience in Australia and some other countries suggest that a streamlined system would work much better than the current overly complex US structure of regulation. The SEC is not the only possible candidate for the consumer protection functions, but it would be the natural home for a strong conduct of business regulator, given its existing role in shareholder protection.

My favorite plan for the proposed CFPA, therefore, is that the group of people that are now doing consumer protection at the FED and the groups at other prudential agencies be relocated to a consumer protection division at the SEC. The FED has neglected consumer protection in the past but in recent months has become good at it. The current head of consumer protection at the FED would make an excellent candidate to be head of the new agency within the SEC.

The CFPA as a standalone agency

The disadvantages of a separate CFPA are twofold. First, this approach adds one more agency to the list. There are already too many agencies and adding another one is a move away from streamlining and consolidating financial regulation.

The second possible problem is that a separate agency is more likely to attract an activist group and end up in an endless fight with the financial industry. It is important that supervisors and regulators have the power and independence to stand up to private industry. But at the same time, they must be able to understand how the industry works, its need for profitable lines of business and challenges it may face from customers that do not always pay their bills.

In the past, I have expressed pretty strong opposition to a standalone agency for the above reasons. At this time, after having spent more time examining the issues, I now accept that a separate agency is a

reasonable outcome that should improve overall regulation and help consumers. It would be important, of course, that it be well-designed and avoid the pitfalls and dangers described earlier.

Conclusion

Improved consumer protection is needed. Had there been better protection prior to the financial crisis this would have ameliorated the severity of the crisis and might even have forestalled it. There are substantial dangers in a CFPB, dangers of over regulation and of stifling innovation. Proposals for blanket prohibitions and for compulsory provision of plain vanilla products are probably a step too far. The emphasis should be on improved transparency and on solving the market failure of inadequate information.

Many consumers lack knowledge and understanding in the financial area, so that disclosure alone is unlikely to be enough to solve the market failures in some areas. Even if it avoids ex ante prohibitions, the consumer protection agency should look for situations where companies are exploiting the lack of consumer knowledge. They should stop sharp practices and perhaps exact penalties on companies that have used them.

My first choice would be for the US to have a single conduct of business regulator and the SEC is the natural home for this agency. I am willing to support a separate agency, however, with the right structure and a staff that is balanced and knowledgeable about markets.