Backgrounder

Published by The Heritage Foundation

No. 2314
September 8, 2009

How to Protect Consumers in the Financial Marketplace: An Alternate Approach

David C. John

The Treasury Department has proposed consolidating the existing consumer protection divisions of the various federal financial regulatory agencies into a new and powerful Consumer Financial Protection Agency (CFPA). The CFPA would be responsible for creating and enforcing the regulation of consumer financial products.[1] On July 9, House Financial Services Committee Chairman Barney Frank introduced a slightly revised version of the Treasury proposal as H.R. 3126[2] and announced his intention to pass the bill as rapidly as possible.

Creating a new agency would be an enormous mistake that would hurt consumers far more than it would help them. A CFPA would raise costs for consumers, reduce the number and type of products available to them, increase the micro-management of financial services firms, and greatly increase the confusion caused by differing and conflicting consumer laws in the different states.

A far better approach would be to coordinate the consumer activities of existing state and federal financial regulators by creating a coordinating council designed to promote equal standards of consumer protection using agencies' existing powers. Critics of the current regulatory system justify the need for a CFPA by citing instances where different agencies applied different regulatory standards to similar products, and pointing to misleading products or unregulated entities that took advantage of consumers. But these problems could just as easily be solved by a coordinating council as by creating a massive new reg-

Talking Points

- The Treasury Department has proposed consolidating the existing consumer protection divisions of the various federal financial regulatory agencies into a new and powerful Consumer Financial Protection Agency (CFPA).
- The CFPA would be responsible for creating and enforcing the regulation of consumer financial products.
- Creating a new agency would be a huge mistake that would hurt consumers far more than it helps them. A CFPA would raise costs for consumers, and reduce the number and kind of products available to them.
- A far better approach would be to coordinate the consumer activities of existing state and federal financial agencies by creating a coordinating council designed to promote equal standards of consumer protection using agencies' existing powers.
- There is no need for a massive new agency when existing agencies could work better, faster, and at little additional cost.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Regulation/bg2314.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation
LEADERSHIP FOR AMERICA

ulator. The council would be managed and staffed by the agencies with an oversight panel of outside experts to monitor its activities and ensure that coverage is universal.

Consumer protections need to be both more effective and apply to all consumers, regardless of the presence of unregulated products or segments of the industry, but there is no need for a massive new agency. Given the right instructions and oversight, the existing state and federal regulators could effectively deal with abuses and gaps between different types of financial institutions. As discussed below, the proposed CFPA could actually make matters worse for consumers by causing chaos while it rearranges the existing regulators into a cumbersome, unresponsive bureaucracy.

A New Bureaucracy Is Not the Answer

Creating a CFPA is unnecessary, and both the Treasury proposal and the draft legislation to implement it are filled with ambiguous grants of almost unlimited power, poorly considered policies, and attempts to micromanage financial products. Among the many weaknesses of the proposed CFPA are:

- **The CFPA could regulate just about anyone.** According to both the House draft and the Treasury proposal, the CFPA would have jurisdiction over any entity that directly or indirectly provides a financial activity,[3] a definition that could cover prepaid funeral services, financial data providers or storage services, as well as financial services firms. This is a huge expansion of federal regulation, as any state-regulated provider that comes under the act would now be federally regulated. In addition, the CFPA would have the very broad power to define through regulation any activity or product that comes under that definition however tangentially as a financial service, thus bringing any company that provides that service or product under its jurisdiction.

  However, the draft legislation is inconsistent, for even under the CFPA, the regulation of consumer products offered by entities regulated by the Securities and Exchange Commission and Commodity Futures Trading Commission (including retirement accounts) would remain solely under the authority of their current regulators, rather than being folded into the new agency. This is also true of insurance companies, which would remain state-regulated even if other companies that offer similar products would fall under the CFPA. While the Treasury Department has proposed bringing the Community Reinvestment Act under the auspices of CFPA, the House bill leaves enforcement of the act up to its current financial regulators, thus adding to the confusion: Do CFPA supporters really see the need for a new agency?

- **The CFPA would be a massive new bureaucracy.** On the surface, the CFPA appears to require no new resources—existing consumer protection personnel would be transferred to the new agency—but the reality would be very different. While the House bill seems to require the transfer of enforcement staff to the CFPA, it also says that any federal agency authorized to enforce a federal law may make a written recommendation that the CFPA initiate an enforcement proceeding if the original agency believes there are violations of consumer protection standards. If the CFPA does not initiate an enforcement proceeding within 120 days of the referral, the original federal agency may use its "backstop" enforcement authority to initiate an enforcement proceeding as permitted by that federal law. If this is the case, then the agencies that currently regulate financial entities would still need to retain enforcement staff, as well as staff who are substantively trained in each area of law for which the federal agency has backstop enforcement authority. Thus, rather than simply transferring staff, the act appears to require either the CFPA to hire additional staff or the current regulators to hire people to replace those moved to the CFPA.

1. A Treasury Department fact sheet, "Strengthening Consumer Protection," on the proposed new agency is available at *http://www.financialstability.gov/docs/regulatoryreform/strengthening_consumer_protection.pdf* (September 1, 2009).
2. H.R. 3126, at *http://www.house.gov/apps/list/press/financialsvcs_dem/21frank_011_xml.pdf* (September 1, 2009).
3. Section 1002 of H.R. 3126.

The Heritage Foundation
LEADERSHIP FOR AMERICA

- **The CFPA's encouragement of stronger state regulations would cripple the national marketplace.** A major weakness of the proposed CFPA is the damage it would do to the national financial market by openly encouraging individual states to define stricter consumer standards that would substitute for the national ones. Most federal laws specify a national standard that states must observe, but the CFPA would explicitly subordinate federal regulations to stronger state laws.

  A strength of the financial market is its ability to offer standardized products that reduce costs to both firms and consumers. However, under the CFPA, national firms could face up to 51 separate consumer regulatory regimes, complete with disputes about whether the applicable standard that applies is the one from the state where a consumer who made a certain purchase lives, or the state where the firm is physically located, or the state where the Internet site that was used is registered. Instead of one product that can be sold across state lines, financial services providers would be forced to create multiple variations that meet various state requirements. As their customers move from state to state, financial firms would be forced to adjust their accounts to meet the standards of the different states to which the customers move. Such a system would be both confusing and costly—a cost that would be passed on to the consumer in the form of higher fees.

  To lessen the confusion, it is likely that many companies would adhere to the strictest standard that is practical for them and abandon customers in states with stricter standards.

- **Financial firms face potential triple jeopardy.** Because of the potential for stricter state regulations, financial services providers could face enforcement actions from as many as three fronts: the CFPA, the backstop federal regulator, or state regulators with stricter standards. While this outcome would certainly provide plenty of business for lawyers, it is questionable if such an arrangement will benefit the consumers who have to pay for the litigation through higher administrative costs.

- **Required "plain vanilla" products could stifle innovation.** The CFPA would be authorized to place tailored restrictions on product terms and provider practices, which appears to mean that customers would be required to explicitly reject basic "plain vanilla" products before they are allowed to buy more complex variations.

  There is a good argument that many financial products are so complex that an average consumer is unlikely to understand all their ramifications, especially in a high pressure sales situation. For that reason, there is a legitimate need for both full disclosure of simpler products that are available and the potential pitfalls of more complex ones.

  However, the proposal assumes that the CFPA will designate specific types of basic products as the defaults that a consumer must be offered—which raises a serious danger that the agency will stick with older products despite innovations that could provide the same risk level at a lower cost. Rather than micromanaging the sales process, financial firms should be required to give full disclosure of available products and the risks of each, a process that could best be accomplished by the current regulators that already understand that industry.

- **Confusion caused by the merger will hurt consumers.** Unfortunately for consumers, merging a number of existing federal offices into a new agency, complete with moving to new locations, a new corporate culture, problems with coordinating activities, and so on, are likely to severely disrupt existing regulatory efforts. This confusion will be compounded by questions of whether existing state regulatory efforts are to be superseded by the CFPA, or if their standards are stricter and, therefore, remain in force. Finally, there will be questions about which private-sector companies actually fall under the new agency's jurisdiction, and by which new rules they must abide. The only winner during this confusion will be trial lawyers, who will be able to exploit the inevitable gaps and mistakes to benefit their clients.

- **Separation of consumer regulation from prudential regulation will damage the financial industry.** Separating the oversight of consumer products from an overall understanding of financial institution operations and financial strengths and weaknesses by segregating consumer regulation in a separate agency is dangerous to both providers and consumers. The proposal requires the CFPA to consult with the federal banking agencies or other federal agencies, as appropriate, to keep the proposed regulations consistent with prudential, market, or systemic objectives. However, consultation only works if both parties have an understanding of the advice being given, and as time goes on and the CFPA focuses exclusively on its consumer rules, the agency will lose its understanding of how various product specifications are shaped by the operational necessities of differing types of financial institutions. Placing consumer regulation in a "silo" is likely to result in decisions that decrease the attractiveness of products, causing many that could be attractive to consumers to be withdrawn or offered only to select groups.

Regulators and others have suggested that, as a compromise, the CFPA would be created to develop consumer regulations, but they would be administered through the existing financial regulators. While this is slightly better than the original proposal, this variation would still suffer from the same weaknesses as the original CFPA.

A Better Approach to Consumer Protection

A better way to improve consumer financial regulation would be to create a council of regulators similar to the one charged with creating uniform standards for the examination of financial institutions, the Federal Financial Institutions Examination Council (FFIEC).[4] The council of consumer financial regulators would be charged with ensuring that existing state and federal regulators have uniform regulatory standards that apply to all types of financial institutions and can meet the challenges posed by complex new financial products. But it leaves the day-to-day enforcement to regulators that understand that type of financial institution and its operational necessities. Such a council has the advantage of neither creating a vast new all-powerful bureaucracy nor completely disrupting current regulatory efforts by merging parts of different agencies.

The council would consist of one representative from each federal agency[5] and elected representatives from councils of the various types of state regulators.[6] In addition, it would have a fully participating chairman[7] appointed by the President and a board of outside expert advisors who would monitor consumer regulatory activities. Staffing would come from within the agencies except for a very small support staff for the chairman and advisors.

The inclusion of state regulators in the council would make coverage even more universal than it would be under the proposed CFPA. Standards agreed to by the council would apply to insurance

4. The FFIEC "is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS), and to make recommendations to promote uniformity in the supervision of financial institutions. In 2006, the State Liaison Committee (SLC) was added to the Council as a voting member. The SLC includes representatives from the Conference of State Bank Supervisors (CSBS), the American Council of State Savings Supervisors (ACSSS), and the National Association of State Credit Union Supervisors (NASCUS)." See *http://www.ffiec.gov/* (September 1, 2009).
5. If existing federal financial regulatory agencies are merged, or new ones are created, the membership of the council would change, but not its purpose or ongoing efforts.
6. Thus, there would be one individual representing state credit union administrators, another representing state banking regulators, and so forth.
7. Council guidelines would be developed by consensus. The outside advisors would submit reports and provide advice to the council, but would not participate in its deliberations.

The Heritage Foundation
LEADERSHIP FOR AMERICA

companies (exempted under the CFPA approach) and as states move to license them, the unregulated mortgage brokers and others who were often responsible for abuses in mortgage lending. Instead of a one-size-fits-all policy dictated by Washington, states would continue to have flexibility in implementing regulations, subject to the oversight of the council and its expert advisors, who could issue public statements and studies to make sure that consumers are aware of states with poor coverage or enforcement. Failure to act could make loans issued in those states ineligible for securitization or sale to investors in other states.

This approach would preserve state regulation of those entities that are currently state-regulated rather than attempting to federalize all aspects of consumer financial relationships.[8] The council would also include both the Securities and Exchange Commission and Commodity Futures Trading Commission, thus closing other gaps in the CFPA as proposed, including the regulation of retirement savings accounts.

The council would be responsible for developing broad standards for consumer regulation while leaving the writing and enforcement of specific regulations to those agencies with responsibilities for that area. This ensures that the regulations take into consideration the operational realities of the regulated institutions as well as any special characteristics of regional markets.[9]

Another key advantage of the council is that by using existing regulators and their current authority, the regulators' individual efforts can be better monitored than the results of the proposed vast new bureaucracy's vague and almost unlimited powers. Through proper congressional oversight and the reports from the new council's expert advisors, Congress can better pinpoint successes and failures than it could by attempting to keep track of the efforts of one massive agency.

New Federal Agency Is Not the Best Way to Help Consumers

While some Members of Congress and the Obama Administration seem to believe that only the creation of a new agency will prove their commitment to ensuring that customers receive both the information and financial product choice that they need, this is not the case. Financial products can be confusing, and consumers can be manipulated into making poor choices. However, improved disclosures and requiring financial institutions to offer basic products to all of their customers with the appropriate credit history, does not mean a whole new federal agency needs to be created. The draft credit card regulations issued by the Federal Reserve last year,[10] for instance, were an effective response to problems in that industry. Although Congress chose to go beyond the Fed's regulations, the quality of the draft regulations demonstrate the ability of the current financial regulators to effectively handle consumer issues.[11]

The CFPA proposal is filled with poorly considered departures from existing law and practice that are as likely to damage consumers' interests as

8. Currently the Uniform Commercial Code, recommended language created by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) and passed by the individual states, sometimes with changes to reflect the circumstances of specific states, ensures that businesses with interstate operations face roughly the same legal climate in all states. Should it be necessary, a similar mechanism could recommend model financial regulatory standards to state legislatures.
9. Since decisions of the council would not have the force of law, implementation of decisions may require the individual agencies to alter their regulations, or even to seek a change to statutes from the relevant state or federal legislative body. Agencies that failed to implement council guidelines would be identified through its reports, and in some cases those reports could recommend that the relevant legislative body impose those decisions through changes in the law.
10. For a summary of the credit card rules approved by the Federal Reserve Board of Governors on December 18, 2008, see "Highlights of Rules Regarding Credit Card Accounts," at *http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a1.pdf* (September 1, 2009).
11. David C. John, "Senate Credit Card Bill Would Restrict Credit for Those Who Need It Most," Heritage Foundation *WebMemo* No. 2435, May 12, 2009, at *http://www.heritage.org/Research/Regulation/wm2435.cfm.*

improve them. Giving any agency such wide powers makes little sense, and encouraging the individual states to create their own higher standards will damage the national market in financial services. Congress should avoid the bad policies contained in the proposed CFPA. The same goals supported by those who propose the creation of a new agency can be better achieved through a coordinating council of existing regulatory agencies. There is no need for a massive new agency when existing agencies could work better, faster, and at little additional cost.

—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

The Heritage Foundation
LEADERSHIP FOR AMERICA