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Unfree to Choose: The Administration's Consumer Financial Protection Agency

By Peter J. Wallison

The administration's proposal for a Consumer Financial Protection Agency (CFPA) promises to be one of the most comprehensive and controversial pieces of regulatory legislation ever presented to Congress. In addition to extending the government's regulatory reach deep into areas now regulated by the states, the proposal would—for the first time—set up a statutory system for denying some financial products and services to consumers who are considered to lack the sophistication or experience to understand them. This is a sharp and unprecedented turn from the traditional disclosure approach to consumer protection, which punished fraud or deception but otherwise assumed that with adequate disclosure all Americans could make their way in a consumer economy. In a real sense, with this proposal, the administration has validated the conservative case that liberalism seeks to control the lives of ordinary Americans but does not interfere with the privileges of the educated elites. Finally, in proposing that the CFPA pursue the “rigorous application” of the Community Reinvestment Act (CRA), the administration has shown that it does not understand how that act contributed to the current financial crisis.

In late June, the administration circulated a white paper outlining its ideas for regulating the financial system. Most of the content simply repeated ideas presented to Congress in late March by Treasury Secretary Timothy Geithner.¹ The only real surprise in the white paper was the inclusion of the CFPA, a new federal-level agency to focus entirely on consumer protection. Because it was new and dramatically framed, the CFPA immediately drew the attention of the press and the concerns of a financial industry that was already feeling beleaguered by the prospect of broad new government regulation. The legislation that followed two weeks later was consistent with the white paper, but the white paper is more descriptive about the administration's intentions than the dry legislative language.

“We propose,” said the white paper, “the creation of a single federal agency . . . dedicated to protecting consumers in the financial products and services markets, except for investment

products and services already regulated by the SEC [Securities and Exchange Commission] or CFTC [Commodity Futures Trading Commission]. We

Key points in this Outlook:

- If it is in fact created, the CFPA will have far-reaching powers, overseeing most facets of consumer financial activity, down to the most basic services at the local level.
- In an unprecedented move, the legislation would require credit providers to discriminate among customers in granting credit and other financial benefits based on a judgment about their sophistication or experience.
- These elements validate the conservative case that liberalism seeks to control the lives of ordinary Americans while preserving the privileges of the elites.
- The legislation requires the “rigorous application” of the Community Reinvestment Act by the CFPA, demonstrating that the administration does not understand the CRA's contribution to the financial crisis.

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recommend that the CFPA be granted consolidated authority over the closely related functions of writing rules, supervising and examining institutions' compliance, and administratively enforcing violations. The CFPA should reduce gaps in federal supervision; improve coordination among the states; set higher standards for financial intermediaries; and promote consistent regulation of similar products."² The jurisdiction of the new agency is intended to be broad, covering "credit, savings and payment products," according to its mission: "to help ensure that . . . consumers have the information they need to make responsible financial decisions . . . [and] are protected from abuse, unfairness, deception or discrimination."³

Hidden in these generalities are powers likely to make the CFPA one of the most controversial proposals ever put forward by an administration. Although the underlying idea of the CFPA probably springs from a well-meaning intention to protect consumers, many Americans—including those the agency intends to protect—will see a reduction in their options as consumers, while the privileges of the more sophisticated and better-educated elites will remain unimpaired.

The Basics

The CFPA is intended to be an independent agency with sole rule-making and enforcement authority for all federal consumer financial protection laws (with the exception of those covered by the SEC and the CFTC). The draft legislation gives the agency jurisdiction over all companies, regardless of size, that are engaged generally in providing credit, savings, collection, or payment services. This is accomplished by transferring to the CFPA most or all of the authorities in sixteen federal statutes—ranging from the CRA to the Truth in Savings Act—that cover lending, mortgage financing, fair housing, credit repair, debt collection practices, fair credit reporting, and a multitude of other consumer financial products and services. The agency will be funded by fees imposed on the thousands of companies—from banks and credit card companies to local finance companies and department stores—that are subject to the legislation.⁴ In many cases, the agency's jurisdiction will be concurrent with the jurisdiction of state agencies, but the CFPA will not preempt state law.

The white paper refers to the agency's regulations as "a floor not a ceiling," thus making room for states to impose

regulations that go beyond those of the CFPA. State agencies will be permitted to enforce the CFPA's regulations, and vice versa.

In some ways, the plan is self-contradictory. The white paper speaks of the need for consistent standards, but the draft legislation leaves untouched the jurisdictions of the SEC, the CFTC, and the jurisdiction of the states with respect to insurance. Thus, the draft legislation sets up the possibility that inconsistent consumer protection standards will apply to products that compete directly with one another. In addition, given the administration's constant refrain about using its regulatory reforms to prevent regulatory arbitrage—in which a regulated entity seeks the most

favorable jurisdiction under which to offer its products—it is odd that the legislation creates these arbitrage opportunities by placing the banks under the CFPA while leaving insurance regulation to the states and securities regulation under the SEC.

As might be expected, the new agency will have jurisdiction over disclosure to consumers. This is the customary way that consumer protection has proceeded at the federal level. In the past, consumers were generally expected to have the ability to make decisions for themselves if they were given the necessary information. The securities laws, for example, are largely consumer protection laws, developed during the New Deal period. In selling a security, an issuing company and any underwriter or dealer must supply investors with all material facts, including any additional facts needed to ensure that the information disclosed is not misleading. This approach has worked well for seventy-five years.

The material facts standard of the SEC is of course subject to interpretation, but it is possible to give it some content by imagining what an investor would want to know about the risks a company faces and its financial and business prospects. The white paper states that the CFPA will use a "reasonableness" standard, which it defines as "balance in the presentation of risks and benefits, as well as clarity and conspicuousness in the description of significant product costs and risks."⁵ The draft legislation follows this pattern, so that disclosure to consumers must—perhaps like a drug label or a securities prospectus—include both the benefits and the risks of a product or service. These will be difficult guidelines for the regulated industry to follow, especially because enforcement actions and lawsuits may result from violations. Despite substantial disclosure

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on drug labels and in securities prospectuses—in some cases ordered by the regulatory agency—successful lawsuits in both areas have claimed that the disclosure was not sufficient.

The Suitability Problem

The real trouble begins, however, when the administration's plan gets beyond the relatively simple issue of disclosure and proposes that the CFPA define standards for what the white paper calls "plain vanilla" products and services. The draft legislation describes them as "standard consumer financial products or services" that will be both "transparent" and "lower risk." According to the white paper, the CFPA will have authority "to require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer."⁶ This idea, seemingly quite simple, raises a host of significant questions. If there is a plain vanilla product, who is going to be eligible for the product that has strawberry sauce? In other words, once the baseline is established for a product that can or must be offered to everyone, who is going to be eligible for the product that, because of its additional but more complex features, offers financial advantages? This is the suitability problem—requiring providers to decide whether a particular product or service is suitable for a particular customer—and the administration's plan is caught in its web.

As an example, consider a mortgage with a prepayment penalty. The white paper notes that the "CFPA could determine that prepayment penalties should be banned for certain types of products, because penalties make loans too complex for the least sophisticated consumers or those least able to shop effectively."⁷ This seems logical if one assumes—as the administration seems prepared to do—that some consumers can be denied access to products they want. As the white paper notes, "[t]he CFPA should be authorized to use a variety of measures to help ensure alternative mortgages were obtained only by consumers who understood the risks and could manage them."⁸ So, what about the husband and wife who intend to keep their home until their children are grown and are willing, for this reason, to accept a prepayment penalty in order to get a lower rate on their fixed-rate mortgage? The

administration is suggesting that this option might not be available to them if the mortgage provider (and ultimately the CFPA) does not consider them "sophisticated" consumers. This kind of discrimination between and among Americans is something new and troubling. The administration's plan clearly intends for some consumers to be denied access to certain products and services. "As mortgages and credit cards illustrate," the white paper declares, "even seemingly 'simple' financial products remain complicated to large numbers of Americans. As a

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result, in addition to meaningful disclosure, there must also be standards of appropriate business conduct and regulations that help ensure providers do not have undue incentives to undermine those standards."⁹ In other words, by requiring that all providers offer plain vanilla products and services in addition to other products, the administration is creating a regime in which providers must keep "complicated" products out of the hands of Americans who may not be able to understand them. Although no specific regulation forbids offering an unsophisticated customer a product that is more complex than the plain vanilla baseline product, the possibility of enforcement

actions by the CFPA or the Federal Trade Commission, suits by state attorneys general (specifically authorized to enforce the CFPA's regulations),¹⁰ and the inevitable class action lawsuits will have this effect. This is not a question of disclosure—making the risks and costs plain. Instead, it is a matter of denying some people access to these products because of their deficiencies in experience, sophistication, and perhaps even intelligence. The white paper notes: "Even if disclosures are fully tested and all communications are properly balanced, product complexity itself can lead consumers to make costly errors."¹¹

This approach seems to be an unprecedented departure by the U.S. government from some of the fundamental ideas of individual equality that have underpinned U.S. society since its inception. Conservatives have long argued that liberalism reflects a paternalistic desire on the part of elites to control and limit others' choices while leaving themselves unaffected. The white paper seems to validate exactly that critique. Providers will be at risk if they offer some products to ordinary consumers but could feel safe in offering the same products to those who are well educated and sophisticated. In important ways, the administration's approach raises the issues in the famous

Louis Brandeis statement, quoted by Milton and Rose Friedman at the beginning of their book, *Free to Choose*: “Experience should teach us to be most on our guard to protect liberty when the government’s purposes are beneficial. Men born to freedom are naturally alert to repel invasion of their liberty by evil-minded rulers. The greater dangers to liberty lurk in insidious encroachment by men of zeal, well-meaning but without understanding.”¹²

In addition, there are troubling questions about how determinations of sophistication or even mental capacity are going to be made, who is going to make them, and what standards will be followed. It appears that the provider must make this decision, but what kinds of guidelines will the CFPA provide to protect the provider against the inevitable legal attacks? Vague language in the legislation suggests the consumer can refuse to take the plain vanilla alternative, but this simply changes the nature of the provider’s risk from the qualities of the product to the qualities of the disclosures that were made to the consumer about what such a waiver would mean. Finally, the elements of a plain vanilla mortgage can be quite arbitrary, forcing people into structures that are financially disadvantageous. How can anyone know, for example, whether a thirty-year fixed-rate mortgage is better than a thirty-year adjustable-rate loan with a reasonable cap on interest costs? If interest rates rise in the future, the fixed-rate mortgage is best, but if they fall, a variable rate should be preferred. Should a government agency have the power to determine whether a homebuyer is allowed to make this choice?

In contrast, the disclosure system has always seemed appropriate in our society because it does not require invidious or arbitrary discrimination between one person and another. As long as the disclosure is fair and honest, why should anyone be prohibited from buying a product or service? While it is apparent that everyone is not equal in understanding or sophistication, our national sensibility has been that these differences should be ignored in favor of the higher ideal of equality. Under this view, fraud and deception should be punished, but the government should not be involved in deciding whether one person or another is eligible to receive what our economy has to offer. Yet the white paper says: “The CFPA should be authorized to use a variety of measures to help ensure that

alternative mortgages were obtained only by consumers who understood the risks and could manage them. For example, the CFPA could . . . require providers to have applicants fill out financial experience questionnaires.”¹³ If this sounds a bit like a literacy or property test for voting—ideas long ago discredited—it is not surprising.

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Both impulses spring from the same source: a sense that some people are not as capable as others to make important choices.

To be sure, the securities laws contemplate that some distinctions will be made among customers on the basis of suitability. A broker-dealer may not sell a securities product to a customer if the customer does not have the resources to bear the risk or the ability to understand its nature. This is the closest analogy to what the administration is contemplating for all consumers, but as a precedent it is inapposite. Owning a security is not a necessity for living in our economically developed society, but obtaining credit certainly is. Whether through a credit card, an account at a food or department store, a car loan, or a lay-away savings plan at a local furniture dealer, credit is a benefit that enables every person and every family to live better in our economy. Denying a credit product suitable to one’s needs but deemed to be beyond one’s capacity to understand has a far greater immediate adverse effect on a family’s standard of living than telling an investor that a collateralized debt obligation is not a suitable product for his 401(k). Moreover, investors tend to be customers of broker-dealers over extended periods, so their financial and other capacities are well known to the brokers who handle their accounts. This is unlikely to be true for various credit products, which are likely to be established in single transactions and with little follow-up. Any attempt to determine a customer’s ability to handle the risks associated with, say, a credit card could also involve investigation into matters that the customer considers private. Neither the draft legislation nor the white paper suggests how the provider of a financial service is to determine suitability while still protecting the customer’s privacy. As discussed below, simply determining what other credit products and obligations particular applicants might have—and thus whether they are able to meet their obligations—will be difficult and costly. These problems do not normally arise in the suitability inquiry that broker-dealers must undertake.

Other Effects

Several other serious problems arise out of the structure that the administration seems to have in mind. The decision on a particular consumer's eligibility for a product will not be made by the CFPA but by the provider of the product or service. Apart from consumers themselves, providers are the first victims of this legislation. They will have to decide—at the risk of a CFPA enforcement action or a likely lawsuit—whether a particular customer is suitable for a particular product. This will place them in a difficult, if not impossible, position. If they accede to a customer's demand, and the customer later complains, the provider may face a costly enforcement proceeding or worse, but if the provider denies the customer the desired product, the provider will be blamed, not the government agency.

In not a few cases, the provider may be sued for denial of credit to someone later deemed suitable, rather than for granting credit to a person later deemed unsuitable. The white paper points out that the administration does not intend to disturb private rights of action and in some cases "may seek legislation to increase statutory damages."¹⁴ As noted above, state attorneys general are specifically authorized to enforce the CFPA's regulations. Although the white paper offers the possibility that a provider might get a "no action letter" or approval of its product and its disclosure, the personal financial condition and other capacities of the customer are what will count, not the simplicity of the product.

The second victim will be innovation. Why should anyone take the risk to create a new product? Even if the CFPA will review it to determine whether it is accurately and fairly described—a process that may require the services of a lawyer and the usual expenses of completing applications and answering questions from a government agency—the developer will still have to decide whether the people who want it are suitable to have it. The suitability decision can be expensive; a provider's better choice might be to stay with plain vanilla products and give up the idea of developing new products to attract new customers.

The third victim will be low-cost credit. The tasks of getting approval for a product and investigating the suitability of every person who wants something more than a plain vanilla product—whatever that may be—will

substantially increase the cost of credit and reduce its availability. Leaving aside the effect on economic growth generally, higher credit costs and the denial of credit facilities that are deemed to be unsuitable for particular consumers will seriously impair the quality of life for many

people of modest means or limited education. Credit provided by stores to regular customers may become too costly to administer. As a result, small neighborhood establishments may simply abandon the idea of providing credit and small finance companies and other small enterprises engaged in consumer financial services may well go out of business or merge with larger competitors. Even large credit providers may find that the additional business they attract with this service does not compensate for the risk and expense. Withdrawal of these competitors from the market will not only mean that many

customers will be deprived of any credit sources and other services, but also that the reduced competition will allow credit fees to rise.

Litigation will also be a factor in the decision of credit sources about whether to develop new products or offer the complex products and services that might lead to disputes with customers or the CFPA. Investor complaints about suitability in the securities field are handled through an arbitration process, so that an investor who claims that he was sold a product for which he was unsuitable must make his case to an arbitrator rather than a court. The current costs of a mistake in the suitability judgment are thus much smaller for the broker-dealer. The legislation would give the CFPA the authority to ban mandatory arbitration clauses in credit arrangements,¹⁵ and the white paper recommends that the SEC consider ending the arbitration process for securities.¹⁶ If the SEC decides to do this, litigation in the securities field will substantially increase the costs of broker-dealers and investment advisers.

Finally, inherent conflicts between consumer protection and prudential regulation will arise when consumer protection responsibility is moved from the bank supervisors to the CFPA. How these might be resolved has not been described in the legislation and, perhaps was not considered. For example, as noted above, the white paper suggests that prepayment penalties should be banned for certain types of products because they make loans too complex for the least sophisticated consumers. A prudential supervisor, however, might want prepayment

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penalties to be included in a prudently underwritten mortgage, since the ability of the borrower to prepay at any time without penalty raises the lender's interest rate risk. It is likely that the bank supervisors and the CFPB will have different policies on this and many other issues, and the banks will be caught in the middle.

The Community Reinvestment Act

One of the most astonishing elements of the administration's plan is its proposal to give the CFPB the authority to enforce the CRA. The white paper states: "Rigorous application of the [CRA] should be a core function of the CFPB. Some have attempted to blame the subprime meltdown and financial crisis on the CRA and have argued that CRA must be weakened in order to restore financial stability. These arguments are without any logical or evidentiary basis. It is not tenable that the CRA could suddenly have caused an explosion in bad subprime loans more than 25 years after its enactment."¹⁷ This statement reflects a troubling ignorance about the CRA, how it works, and its significance in creating subprime and other nontraditional mortgages. For example, the following report appears in the National Community Reinvestment Coalition's 2007 publication entitled *CRA Commitments* and describes quite clearly how the CRA's requirements created leverage for the creation of huge numbers of subprime and other nontraditional loans:

Since the passage of CRA in 1977, lenders and community organizations have signed over 446 CRA agreements totaling more than \$4.5 trillion in reinvestment dollars flowing to minority and lower income neighborhoods.

Lenders and community groups will often sign these agreements when a lender has submitted an application to merge with another institution or expand its services. Lenders must seek the approval of federal regulators for their plans to merge or change their services. The four federal financial institution regulatory agencies will scrutinize the CRA records of lenders and will assess the likely future community reinvestment performance of lenders. The application process, therefore, provides

an incentive for lenders to sign CRA agreements with community groups that will improve their CRA performance. Recognizing the important role of collaboration between lenders and community groups, the federal agencies have established mechanisms in their application procedures that encourage dialogue and cooperation among the parties in preserving and strengthening community reinvestment.¹⁸

Thus, the CRA's requirement that banks show good CRA compliance records in connection with their applications for regulatory approval to merge has enabled interested groups to pressure them into making more than \$4.5 trillion in loan commitments for loans—subprime and other nontraditional mortgages—that would qualify under the CRA. CRA regulations provide that a bank earns a rating of "outstanding"—and thus can expect its merger or expansion applications to be approved—if it demonstrates "extensive use of innovative or flexible lending practices."¹⁹ It is not clear what this administration thinks this language means, but there was no doubt in the mind of a banker who wrote the following to his shareholders in early 2009:

Under the umbrella of the Community Reinvestment Act (CRA), a tremendous amount of pressure was put on banks by the regulatory authorities to make loans, especially mortgage loans, to low income borrowers and neighborhoods. The regulators were very heavy handed regarding this issue. I will not dwell on it here but they required [our bank] to change its mortgage lending practices to meet certain CRA goals, even though we argued the changes were risky and imprudent.

The loans made under these commitments—ultimately sold to Fannie Mae and Freddie Mac and to the Wall Street investment banks—are failing in unprecedented numbers and weakening all financial institutions that hold them. If we are looking for a primary cause of today's financial crisis, it is here. By advocating "rigorous application" of the CRA by the new CFPB, the administration is again setting up the conditions for flooding the financial markets with subprime loans. If the bank supervisors were not concerned about the effect of the CRA on prudent

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lending practices, it is highly unlikely that the CFPB will give any priority to this problem.

There is, finally, a serious contradiction between the administration's call for support for "rigorous application of CRA" and its view that only plain vanilla mortgages are suitable for borrowers who lack sophistication. Unfortunately, the "innovative or flexible lending practices" demanded by the CRA regulations require banks to make subprime and nontraditional loans in the communities they serve. This is because many borrowers in these communities have blemished credit, low FICO scores, insufficient funds for down payments, insecure employment, and low incomes. Subprime loans and nontraditional loans are not plain vanilla loans. They are the kinds of risky loans the CFPB is supposed to prevent because their high failure rate ultimately hurts the consumers who have taken them and the communities in which the borrowers live. If the administration believes that a "plain vanilla" loan can be subprime, then it is either not serious about creating simple loans without substantial associated risk or not serious about a "rigorous application" of the CRA.

Conclusion

The Consumer Financial Protection Agency Act of 2009 is one of the most far-reaching and intrusive federal laws ever proposed by an administration. Not only does it reach down to regulate the most local levels of commercial activity, but the act would also set up procedures and incentives that will inevitably deny some consumers an opportunity to obtain products and services that are readily available to others. It will be surprising if Congress—once it sees the legislation in this light—adopts it.

Notes

1. For commentary on these earlier proposals, see Peter J. Wallison, "Risky Business: Casting the Fed as a Systemic Regulator,"

Financial Services Outlook (February 2009), available at www.aei.org/outlook/100006; and Peter J. Wallison, "Reinventing GSEs: Treasury's Plan for Financial Restructuring," *Financial Services Outlook* (March/April 2009), available at www.aei.org/outlook/100027.

2. U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation* (June 30, 2009), 55–56, available at www.financialstability.gov/docs/regs/FinalReport_web.pdf (accessed July 6, 2009).

3. *Ibid.*, 57.

4. *Consumer Financial Protection Agency Act of 2009*, § 1018, as proposed by the U.S. Department of the Treasury, June 30, 2009, available at www.financialstability.gov/docs/CFPA-Act.pdf (accessed July 6, 2009).

5. U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, 64.

6. *Ibid.*, 15.

7. *Ibid.*, 68.

8. *Ibid.*, 66.

9. *Ibid.*, 67.

10. *Consumer Financial Protection Agency Act of 2009*, § 1042.

11. U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, 66.

12. *Olmstead v. United States*, 277 U.S. 479 (1928).

13. U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, 66.

14. *Ibid.*, 58.

15. *Consumer Financial Protection Agency Act of 2009*, § 1025.

16. U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, 72.

17. *Ibid.*, 69.

18. National Community Investment Coalition, *CRA Commitments* (September 2007), 4, available at www.ncrc.org/images/stories/whatWeDo_promote/cra_commitments_07.pdf (accessed July 6, 2009). Emphasis added.

19. Comptroller of the Currency Administrator of National Banks, "CRA Regulation—Appendix A: Ratings," available at www.occ.treas.gov/cra/cra-appa.htm (accessed July 6, 2009).