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On the Issues

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Do We Need a Consumer Financial Protection Agency?

AEI scholars have been examining the Obama administration's recently proposed creation of a Consumer Financial Protection Agency (CFPA) as part of its package of new financial regulations. Peter J. Wallison discusses the dangers to consumers, saying that if the CFPA is adopted, many consumers may be told they cannot have certain financial products or services because they are not deemed sophisticated enough. Alex J. Pollock testified before the House Financial Services Committee about other ills in the CFPA. While he says it is a good idea to ensure "clear, simple, straightforward, informative disclosures," the CFPA would be an unnecessary bureaucracy likely to put undue pressure on small financial firms while ignoring important issues, like how to deal with Fannie Mae and Freddie Mac. The CFPA may also make it difficult for the government to attract the capital it needs for the banking system.

Elitist Protection Consumers Don't Need

By Peter J. Wallison

Are consumers "protected" when they are denied the opportunity to buy products and services that are available to others? Is that what consumers want? Does it matter what they want?

These are the questions raised by the Obama administration's proposal for the CFPA. Traditionally, consumer protection in the United States has focused on disclosure. It has always been assumed that with adequate disclosure all consumers—of whatever level of sophistication—could make rational decisions about the products and services they are offered. No more. If the administration's plan is adopted, many consumers will be told that they cannot have particular products or services because they are not sophisticated, educated, or (perhaps) intelligent enough to understand what they have been offered.

Conservatives have always argued that liberals are elitists who do not respect ordinary Americans; this legislation seems to prove it. For example, the administration's plan would allow the educated and sophisticated elites to have access to whatever

Key points in this *On the Issues*:

- The proposed Consumer Financial Protection Agency could deny financial products and services to a portion of the population because they are not sophisticated enough to understand what they are offered.
- If enacted, the CFPA will put undue burden on smaller financial companies, just as Sarbanes-Oxley put great burdens on small firms.
- The CFPA fails to address the future of Fannie Mae and Freddie Mac, weakening its ability to address the issues of the mortgage finance system.
- The increased regulatory burden the CFPA would create may make it difficult for the government to attract the large amounts of private equity capital needed in the banking system.

financial services they want but limit the range of products available to ordinary Americans.

This unprecedented result comes about because, under the proposed legislation, every provider of a financial service (a term that includes organizations as varied as banks, check-cashing services, leasing companies, and payment services) is required to offer a "standard" product or service—to be defined and approved by the proposed agency—that will be simple and entail "lower risks" for consumers. These standard products are called "plain vanilla" in the white paper that the administration circulated in advance of the legislation.

For the first time in our history, the government will force a major sector of the U.S. economy to deny products and services to a large proportion of the population—not because the products or services are inherently dangerous, like drugs or explosives, but because in the view of the Obama administration no amount of disclosure can make some Americans capable of understanding what they are buying.

Thus, the obvious question: once the CFPA has prescribed what is a lower-risk and simpler mortgage loan or other product, who will be able to buy the more complex products that are tailored to a consumer's specific needs? Providers can offer such products, but going beyond the standard plain-vanilla product is likely to entail substantial risks. The provider that sells a more complex product to a consumer who is not ultimately deemed to be capable of understanding the product's risk or complexity could face an enforcement proceeding from the agency (fines, civil penalties, and cease-and-desist orders are authorized in the draft legislation), an action by a state attorney general enforcing the agency's regulations (specifically permitted in the legislation), and a civil suit by a consumer or a class of consumers who claim they did not understand the risks associated with the non-plain-vanilla product or service.

Apparently, adequate disclosure will not be the answer to the provider's dilemma. As outlined in the white paper, no amount of disclosure can adequately protect consumers against complexity: "Even if disclosures are fully tested and all communications are properly balanced, product complexity itself can lead consumers to make costly errors."

How would a provider be expected to determine whether a product that involves more risk or complexity than the plain-vanilla version is suitable for a consumer? The white paper offers this: "The CFPA should be authorized to use a variety of measures to help ensure [non-plain-vanilla] mortgages were obtained only by consumers who understood the risks and could manage them. For example, the CFPA could impose a strong warning label on all [complex] products; require providers to have applicants fill out financial experience questionnaires; or require providers to obtain the applicant's written 'opt-in' to such products."

Of course, if the issue is whether the consumer understood the risks of the more complex product, strong warning labels or written "opt-ins" simply raise the same question and will not be a defense for the provider. And one can only imagine the humiliation of the consumer who must fill out a questionnaire to establish his capacity to purchase anything more than the plain-vanilla product.

So who will be able to get those more complex products and services? Not ordinary Americans, whose lack of financial sophistication will make the risks of selling to them too great for most providers. The more complex products, the ones that are better tailored to the needs of the particular consumer, will be offered only to the more sophisticated and better educated—in other words, to the nation's elites. In this way, and for the first time in our history, the government will force a major sector of the U.S. economy to deny products and services to a large proportion of the population—not because the products or services are inherently dangerous, like drugs or explosives, but because in the view of the Obama administration no amount of disclosure can make some Americans capable of understanding what they are buying.

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One Good Idea and a Number of Bad Ones

By Alex J. Pollock

Mr. Chairman, Ranking Member Bachus, and members of the committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I spent thirty-five years in banking, including twelve years as president and CEO of the Federal Home Loan Bank of Chicago. I have experienced and studied many cycles of financial bubbles and busts, including the political reactions and overreactions that inevitably follow. It appears to me that the proposals we are considering represent the normal political reaction phase.

I think we can all agree as a matter of objective interpretation that the CFPA as proposed would be a highly intrusive, large, very expensive bureaucracy with broad, rather undefined, and potentially arbitrary powers, which would impose large costs on consumer financial services while also imposing requirements that would be likely to conflict with those of other regulatory agencies. Where we differ is that some of us like the idea of having such a bureaucracy, and some of us, including me, do not.

According to the administration's white paper on regulatory restructuring, the proposed CFPA would not only "define standards for 'plain vanilla' products," that is, define products, but also "be authorized to require all providers and intermediaries to offer these products." All "providers and intermediaries"—a vast jurisdiction apparently unrelated to any chartering definitions—would have part of their business dictated by this agency. That is a truly amazing assertion.

Moreover, the CFPA should "be authorized to place tailored restrictions"—that is, restrictions—"on product terms and provider practices." "Terms" presumably includes pricing. Does it include credit standards, such as required down payments?

A more sensible proposal would have been to define certain financial products as "plain vanilla" and require disclosure that "this is (or is not) a plain vanilla financial product suitable for an unsophisticated customer." But this idea, which strikes me as reasonable, would not require a new agency. I will discuss disclosures more in a moment.

The CFPA is to have sole authority, for example, to define the meaning of "reasonable." This is by no means an easy legal or philosophical project. It would also have supervisory, examination, and "a full range of enforcement powers." For financial institutions, it would be an additional, parallel regulatory system representing a major burden, a potentially punitive approach, and significant regulatory risk: this is likely to be quite at odds with the intense desire of the government to attract additional capital into the banking system.

The first major regulatory overreaction of the twenty-first century, the Sarbanes-Oxley Act, proved highly successful at generating cost and bureaucracy, while apparently having no influence at impeding the build-up of risk. For large companies, it was proportionately less of a problem, since they simply created internal corporate bureaucracies to deal with its demands. But it created, and still creates, disproportionate burdens on small and venture businesses. I believe we would see a similar pattern for a CFPA: large financial companies would respond in the same way as they did for Sarbanes-Oxley, and small ones would be disproportionately burdened.

Community banks had and have little to do with the issues of the complex mortgages and mortgage securities that led to the panic and bust. Should Congress ever proceed with a CFPA, it would be reasonable to exempt all community financial institutions.

One Good Idea: Clear, Simple Disclosures

The administration's proposal emphasizes one very good idea: ensuring clear, simple, straightforward, informative disclosures. Of course, we do not need a CFPA to achieve this.

In congressional testimony in the spring of 2007, I proposed a one-page mortgage form so borrowers could easily focus on what they really need to know. The one-page form idea was included in bills in both the House and Senate, but not enacted, unfortunately. It remains my opinion that something like it would be a huge improvement in the way the American mortgage system works.

Subsequently, at the request of a member of Congress, I designed a one-page overdraft form. It seems to me that this approach would be valuable in consumer financial services generally, but it is most important for mortgages because that is by far the largest debt and financial commitment for most households.

By far the most important use of mortgage disclosures is for borrowers to be able to underwrite themselves—that is, to decide whether they can afford the debt service commitments they are making. In the ideal case, the borrowers would be able correctly to complete the one-page form themselves.

In my view, the indubitably best consumer protection is the ability to exercise personal responsibility in making informed decisions about underwriting yourself for the credit and about how much risk you wish to take. This is the best reason to have clear and straightforward disclosures: not just to get understandable information, but to act on it. This is why I believe, by the way, it is essential to have the one-page form, or any variation of it, include the signature of the borrowers.

A Missing Idea: Personal Responsibility

With this as context, it seems remarkable to me that the idea of enabling and building personal responsibility on the part of consumers does not seem to appear anywhere in the administration's proposal. One of my friends did a computer search of the white paper for the term, "personal responsibility," and got zero hits.

Another Missing Idea: Fannie and Freddie

While looking to restructure regulation of the entire financial system, the administration's white paper gets to Fannie Mae and Freddie Mac and loses its courage, merely concluding that they need to be studied further.

But it is impossible to address the issues of the mortgage finance system, or indeed the problems of the bubble and bust, or the problems of defaulted nonprime mortgage borrowers, without addressing Fannie and Freddie. As everybody knows, they represent a vast half of all outstanding residential mortgage credit; they made a huge contribution to inflating the mortgage bubble; they plunged into low quality mortgage credit and pushed the top higher; and they accumulated hundreds of billions of dollars of subprime and nonprime mortgages, the defaults on which have driven them into insolvency. Fannie and Freddie's operations dominate and shape the mortgage market—now more than ever, ironically.

What is the relationship of Fannie and Freddie to the CFPA proposed to be? Without addressing this issue, the proposal leaves a central issue of the mortgage market unanswered.

A Bad Idea: CRA in the CFPA

The CFPA is proposed to have "sole authority to evaluate institutions under the CRA [Community Reinvestment Act]" and to "promote community development investment," taking these responsibilities away from the existing regulators. I believe this is a truly bad idea.

The proposal believes there is a "conflict" between the CRA and safety-and-soundness responsibilities. On the contrary, I believe that whenever credit risk and investment risk are involved, it is absolutely necessary to balance between "community investment" and safety and soundness. Thus, it is imperative for such responsibilities to be combined in one regulatory agency. The alternative, to have credit and investment being "promoted" by people with no responsibility for safety and soundness, appears to me worse than dubious.

Conflict among Regulators

Moreover, the preceding issue points out an obvious question: what happens when the safety-and-soundness regulator disagrees with the CFPA? It seems to me such disagreements are inevitable. The question is simply unaddressed in the proposal.

Sitting, as we are, in the wake of a credit collapse, it should be readily concluded that the superior authority should be placed with responsibility for safety and soundness. A more straightforward solution to this issue, if one wants to keep the idea of centralizing consumer protection and disclosure responsibilities, is to make use of a logical existing organization and drop the notion of the CFPA. My suggestion would be to use the Federal Reserve. It seems to me the Fed is highly qualified for this responsibility.

Attracting Capital

As a final thought, I would like to repeat that any proposals that substantially increase regulatory burden and regulatory risk must be considered in the light of the government's intense need to attract very large amounts of additional private equity capital into the banking system. Thank you again for the chance to share these views.

Alex J. Pollock is a resident fellow at AEI. A version of this testimony was presented to the House Financial Services Committee on June 24, 2009.