Responding to the 2007- 09 financial crisis: A new Consumer Financial Protection Agency?

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President Obama has released a sweeping plan to respond to the financial crisis and to insure that it is not repeated by altering and expanding the federal regulatory framework for financial services firms.[1] The plan outlines detailed and demanding reporting deadlines for various existing federal regulatory institutions to formulate plans for the changes and asks Congress for action on the plan by the end of this year. One of the main components of the plan is to create a new federal agency, the Consumer Financial Protection Agency (CFPA), to protect consumers and investors from deceptive or dangerous products. This is one of the four broad components of comprehensive regulatory reform proposed by the President and the one that has received the greatest endorsement from congressional leaders in terms of the urgency of action. The others address systemic risk, eliminating gaps in the regulatory structure and fostering international coordination.

Not surprisingly, the financial services industry has responded, arguing that a new regulator for consumer protection is not necessary and that it contradicts one of the principal goals of regulatory reform. That goal has been to make the regulatory system more efficient, and principally to do that by reducing the number of regulators. Jamie Dimon, Chair and CEO of J.P. Morgan Chase, argues that:

> Before creating an entirely new federal bureaucracy, policy makers should first examine ways to strengthen and refocus the authority of existing regulators. The primary regulators of financial institutions must be responsible and held accountable for protecting consumers.[2]

Changing the status quo

There currently are four federal banking regulators: the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (OTS). The Obama plan responds to this multiplicity by terminating the OTS and merging its supervisory responsibilities into a consolidated National Bank Supervisor with the OCC. In the process, the plan aims to eliminate the national savings and loan, or thrift, charter. This will create opposition from the 7000+ existing thrifts. On net, there will be no change in the number of federal regulators because all banks and thrifts will confront the new

[1] See U.S. Department of Treasury (2009).
[2] See Dimon (2009).

CFPA. Another area where regulatory consolidation was expected is for securities and their related derivative products.[3] The Obama plan is silent on this objective, however.
Bank regulators, especially the Federal Reserve, currently have broad legal responsibilities for consumer protection under the Truth in Lending legislation and the Home Mortgage Disclosure Act (HMDA), Home Ownership and Equity Protection Act (HOEPA), and the Community Reinvestment Act (CRA), among a plethora of federal consumer protection laws. Rule making and enforcement of these laws would transfer to the CFPA, fragmenting existing regulatory relationships and introducing a new regulator.

An unintended consequence: easing in a Federal role for insurance regulation

One advantage of having a new CFPA, but certainly not one central to its formulation, would be that it could facilitate the introduction of a new federal charter for insurance companies. This proposal has been central to research efforts at Networks Financial Institute, which has held six conferences on financial regulatory reform that center principally on issues involved with an optional federal charter (OFC) for insurance companies, which would allow insurance companies to receive their charter and be regulated by states, as is the case now, or to choose a federal charter and regulator. Former Secretary of Treasury Henry Paulson called for such a new federal regulatory reform in the Department of Treasury Blueprint (2008). The Obama plan does not call for a mandated or optional federal charter, though it does indicate support for an OFC. The CFPA addresses one of the principal hurdles of an OFC by providing a national agency to oversee consumer protection of financial products. Insurance companies receive a large number of consumer complaints each year, a lot more than banks, thrifts or security regulators. Because of the relative large numbers and the supposed efficiency of handling those complaints at the state level, closer to home, critics of an OFC have focused on the consumer protection aspect as a major hurdle for the OFC. The CFPA would provide the same quality of response for consumer insurance complaints as exist for existing federal national regulators.
Tennyson (2008) estimates that state insurance regulators faced 393,482 complaints in 2006, nearly eight times as many as all federal bank regulators combined (54,354), more than twice the number received by the Consumer Product Safety Commission (157,200). The number of insurance complaints is smaller than complaints filed with the Federal Trade Commission

[3] Currently the Securities Exchange Commission (SEC) regulates corporate financial disclosure and issuance and markets for securities, while the Commodity Futures Trading Corporation (CFTC) regulates futures and some other derivative products. Many market participants expected that the CFTC and SEC would be merged to simplify and consolidate federal regulation, but this was absent from the plan, as called for, for example, by the Paulson plan (2008).

(674,354) which seems to handle locally based complaints as adequately as state insurance regulators, though their relative efficiency has not been established. Nonetheless, it is the large number of complaints that suggest to some parties that insurance regulation should occur closer to the consumer, at the state level.

Inadequate consumer protection or financial industry protection?

Do consumers require more protection or investors in One of the principal oversights of the CFPA plan, however, is that it presumes that consumer protection begins at the retail level with transactions between consumers and retail financial services firms. In many cases this is true, but existing regulatory bodies are prepared to deal with such consumer issues and complaints, at least for banking and securities. There have been consumer protection issues linked to the recent financial crisis, especially innovative mortgage lending programs, but the greater problems were the introduction and take up of new sophisticated financial products by banks and other financial institutions, not consumers. It was the banks that lost billions of dollars directly and whose holdings of so-called "toxic assets" caused the breakdown in the nation's credit markets and the freeze up of housing markets and consequent losses of homeowner equity.[4] No doubt there were consumer protection issues related to subprime loans and credit cards, but the Federal Reserve, U.S. Department of Housing and Urban Development and Federal Housing Administration have already designed new rules aimed at most of the consumer problems to avoid a repeat of this crisis.

The CFPA would regulate new mortgage instruments such as subprime adjustable rate mortgages or alternative mortgages that required no income, no documentation or interest only options, for example. Availability of these loans allowed many consumers to bet on price appreciation to allow for loan refinancing that would make their loans affordable to some loans to individuals who could not afford their loans under any conditions. The financial services industry has a strong financial interest in insuring that its new products can withstand shocks and changes in risk or liquidity premia, but this was true before the crisis and apparently innovative firms failed to adequately protect themselves from marketing faulty new products to each other. The risk of liability for product failures did not protect sophisticated financial institutions from their own new products.

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[4] Thomas Hoenig, President of the Federal Reserve Bank of Kansas City, (2009) emphasizes that for reform to work, it is essential to remove senior executives who fail to understand the products they buy and trade. He notes that ". . . far too few senior executives in these largest organizations believed it was their responsibility to understand the financial products their company was buying and trading in quantities of billions and trillions of dollars. This is not only unacceptable, but also a dereliction of duty."

What is arguably missing, and may be addressed in the Obama plan by new regulatory proposals for banks and for the new financial stability regulator, is a financial product safety framework that tests the risks of financial products and restricts market introduction of severely flawed financial products, such as alternative mortgages, auction rate securities, mortgage backed securities, collateralized debt obligations, and perhaps credit default swaps, all instruments that suddenly became much riskier and suffered large declines in originations or trading over the last two years because of fundamental flaws in product design. Such an oversight is not a fatal flaw or unusual in such a sweeping activity as financial regulatory reform. Firms have incentives to develop and market such expertise, but this aspect of financial innovations has failed to a large degree in the past several years. One of the insider disputes in Congress will be whether a new CFPA would usurp or dilute powers over financial markets of the Federal Trade Commission, but a more useful focus would be on whether the greater gap is in the absence of an Investor Product Safety Commission, along the lines of the existing Consumer Product Safety Commission.

Much attention internationally has focused on increased regulation of hedge funds and private equity funds, despite the absence of evidence that these played any role in creating or contributing to the financial crisis in the U.S. or abroad.[5] For example, it was German pressure that led the Group of 20 (G-20) to agree to increase regulation of systemically important hedge funds.[6] Congress and regulators also have toughened credit card rules, beginning in 2010. [7] In the case of testing innovative financial products, the industry and specific trade groups will find increased incentives to respond to the product failures of the past two to three years, though such incentives failed earlier.

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[5] Krauss identifies the concern for hedge funds and their regulation as a continental European issue, and that “there Is not one economist in the United States who believes that hedge funds were the cause of the crisis” He describes the U.K. incentive to avoid excessive hedge fund regulation because of its relative share of the hedge fund business and France and other powers interest in regulation as a protectionist device to gain a share of the business from the U.K. He argues, however, that the damage to the investor class in Europe will be great because excessive regulation will drive hedge funds off shore, restricting the ability to invest through hedge funds. Cassar and Gerakos (2009) show that the restriction of hedge fund access to high-income investors has led to increased internal controls at U.S. hedge funds that provide greater consumer protection and that in Europe, where less regulatory and legal support protects investors in hedge funds, internal controls are even more developed and transparent.

[6] See the G-20 communiqué (2009).

[7] Tightening credit card regulation through the Credit Card Accountability, Responsibility and Disclosure Act or Credit CARD Act signed on May 22, 2009, will restrict credit card companies from altering interest rates or applying higher rates to existing balances without more advance notice and it will restrict the availability of credit cards to persons under 21.

Will a growing Nanny State reduce consumer opportunities and welfare?
The financial crisis and recession have led to calls for fundamental regulatory reform that go well beyond proposals that had developed before the financial crisis and recession. These moves threaten to reverse the deregulation movement that reached its greatest successes in the deregulation of trucking, airlines, communications, the security industry and banking in the 1970s and early 1980s, despite the tremendous improvements of access, quality, pricing and market stability in these industries. Despite recessionary declines in business activity in these industries, consumers have benefited greatly over the past thirty years from the increased competition, new product availability, and lower prices that deregulation has yielded in each of these industries, as well as from the leading role in economic growth from these sectors that deregulation fostered.

More importantly, the direction of new financial regulation threatens to directly remove opportunities for individuals to arrange their financial affairs so as to boost their wealth and financial security, especially opportunities for the least advantaged, the young and the ambitious. Wallison (2009) has noted the irony that Congress may adopt rules that deny the opportunity for ordinary Americans to obtain certain credit or other financial products, while not interfering with the privileges of an educated elite. As he explains, the CFPA would rewrite the standard for consumer protection from a disclosure based system that punishes fraud and deception to a regime that denies that adequately informed consumers provide their own best consumer protection.

The recent response of the Federal Reserve in amending Regulation Z to better protect home mortgage borrowers illustrate a key beginning of the trend. New regulations require all lenders, not just those under the regular purview of the Federal Reserve, to require escrow accounts for taxes and insurance, and outlaw "no money down," "no doc" loans and "no income" loans.[8] These restrictions limit opportunities simultaneously of the less advantaged and the beginning entrepreneurial members of society. Zywicki (2009) details the losses to various consumer groups from these restrictions and the underlying presumption of a "one-size fits all" government-mandated loan product. Regulators under a CFPA are likely to extend the erroneous line of reasoning that it was ignorant consumers with inadequate consumer protection, who created the subprime mortgage and financial crises rather than government policies and problematic financial innovations that provided them with new incentives and attracted them into poorly-timed opportunities that earlier would have significantly advanced their wealth and wellbeing. As Zywicki notes, one wonders if the credit card revolution that brought greater access and lower pricing of consumer credit to millions of consumers would have been

[8] See Federal Register (2008).

allowed to flourish and expand consumer welfare under a CFPA. Eventually self-interested consumers and the financial services firms who accommodate their demands are likely to innovate around such restrictions on consumer choice, but only at great cost and loss of time sensitive opportunities.

The Obama plan was drafted and put forward in this crisis atmosphere and congressional action will have to balance short-term crisis pressures with their long-term objectives for reform in coming months. Rahm Emmanuel's reminder--"*You never want a serious crisis to go to waste. And what I mean by that is an opportunity to do things you think you could not do before*" --describes the atmosphere. [9]The current financial crisis offers a valuable opportunity to take unprecedented and questionable government actions that are totally unrelated to the crisis and perhaps would be clearly undesirable for most of us under other circumstances. What is more troubling, however, is the degree to which regulatory reform plans miss any problem that contributed to the situation, while pursuing less relevant, but politically more visible concerns. In the case of testing innovative financial products, the industry and specific trade groups will find increased incentives to respond to the product failures of the past two to three years, but the CFPA could complicate these efforts.

The Obama plan moves the ball forward into the congressional court where significant financial regulatory reform may actually come to fruition. However, the declining severity of the financial crisis and the end of the recession could threaten the dynamic of reform, and as currently conceived, that could be a good thing. But these circumstances may also allow policy makers to temper the urge to return to excessive or costly regulation and to leave ample room for fundamental financial regulatory reform that has been on the national agenda for several years.

[9] Rahm Emmanuel,speaking to the *Wall Street Journal* Digital Network, November 19, 2008.

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