Statement before the Senate Committee on
Banking, Housing, and Urban Affairs

On "Creating a Consumer Financial Protection Agency:
A Cornerstone of America's New Economic Foundation"

The Consumer Financial Protection Agency

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July 14, 2009

The Consumer Financial Protection Agency (CFPA), as proposed by the Obama administration, 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[1] submitted by the administration 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. In many cases, the agency's jurisdiction will be concurrent with the jurisdiction of state agencies, but the CFPA will not preempt state law.

Prior to submitting the legislation, the administration circulated a white paper[2] that contains clear statements of the policies and intentions underlying the legislation. In this testimony, I will refer to the white paper as well as the legislation itself.

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

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[1] *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).

[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).

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."[3] 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."[4] 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."[5]

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 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."[6] 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.

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[3] Ibid., 15.

[4] Ibid., 68.

[5] Ibid., 66.

[6] Ibid., 67.

This approach bears a strong resemblance to a paper published in October 2008 by the New America Foundation.[7] One of the authors of the piece, Michael Barr, is now an assistant secretary of the Treasury. The underlying theory of the Barr paper is that consumers should be offered a baseline, simple and low risk version of every product offered by credit and other financial providers. This simple product is called a "plain vanilla" product in the New America Foundation paper, just as it is in the administration's white paper. Referring to mortgages, the Barr paper describes this sequence of events: "Borrowers…would get the standard mortgage offered, unless they chose to opt out in favor of a non-standard [i.e. more complex and risky] option offered by the lender, after honest and comprehensible disclosures from brokers and lenders about the terms and risks of the alternative mortgages. An opt-out mortgage system would mean borrowers would be more likely to get straightforward loans they could understand."[8]

What the Barr paper fails to understand is the risks that are faced by the provider in offering to customers anything more complex than the plain vanilla product. Although providers will be free to do so, 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), and the inevitable class action lawsuits will make the offering of the more complex product very risky. Although the Barr paper suggests that the provider can protect itself by making a full and fair disclosure, even the white paper recognizes that this is unlikely to be effective. 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."[9] When these costly errors are made, they will be prima facie evidence that the product was too complex for the consumer, and the provider will be faced with a fine, an expensive enforcement action, or worse. Thus, we are not talking about a question of disclosure—making the risks and costs plain. Instead, what the administration is setting up is a mechanism that will ultimately deny some people access to some products because of their deficiencies in experience, sophistication, and perhaps even intelligence.

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

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[7] Michael Barr, et al, "Behaviorally Informed Financial Services Regulation," New America Foundation, October 2008.

[8] Ibid., 9.

[9] White paper, 66.

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."[10]

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 opt out of the plain vanilla alternative, but as noted above 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 an opt out 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. Where consumers of limited understanding are protected by this system is through consumer protection actions that charge providers with fraud and deception while taking into account the limited capacities of the consumer. Under this approach, fraud and deception are punished, but the government is not involved *ex ante* 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."[11] If this sounds a bit like a literacy or property test for voting—ideas long ago discredited—it is not surprising. 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

[10] *Olmstead v. United States*, 277 U.S. 479 (1928).

[11] White paper, 66.

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." 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, and the white paper recommends that the SEC consider ending the arbitration process for securities. 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 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 CFPA will have different policies on this and many other issues, and the banks will be caught in the middle.

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. This legislation should be rejected.