Chapter 18*

Consumer Financial Protection Agency: Is There a Need?

Overview

There has been growing concern in recent years that many consumers lack the knowledge they need to evaluate and make decisions about financial products. Some of the most important decisions consumers make in their lifetimes involve financial products: a mortgage to purchase a home, a loan to purchase an automobile, credit to make a large durable purchase, investments for retirement, and insurance to keep one's family secure. In the past, the government and employers often made financial decisions for households, for example by providing defined benefit retirement plans or social security; now, however, households are more frequently on their own. Furthermore, financial products have become increasingly complex over time and consumers face a wide range of product options offered by different service providers, making decision-making more complicated. Consumers need to be financially literate in order to make well-informed choices for such complex decisions.

Markets effectively allocate resources toward their best use if participants have the necessary information at hand and understand their choices. However, when it comes to personal finance, this premise must be questioned. Studies show that many consumers lack the basic financial knowledge they need to make informed decisions. To make matters worse, there is growing concern that some financial firms purposely design and proactively advertise products to mislead consumers about the benefits versus the risks.[i] These market imperfections can lead to a misallocation of resources and are the basis for past and proposed government intervention involving consumer protection.

The Crisis

As part of their response to the current financial crisis, the U.S. Congress and Senate have proposed the creation of a Consumer Financial Protection Agency (CFPA). The intent of the CFPA is to unify the supervision and enforcement of existing protection laws in consumer finance and to enhance financial literacy among the public. According to the Senate's proposal, the agency is necessary because "the economic crisis was driven by an across-the-board failure to protect consumers." While we believe that the primary cause of the crisis was the risk-taking of banks, consumer protection was certainly lacking, and we therefore strongly support the creation of a Consumer Financial Protection Agency.

Although consumer protection laws were in place prior to the recent financial crisis, they were clearly ineffective. The authority for enforcement is currently in the hands of at least 11 agencies. All of them have responsibility for only a subgroup of financial firms, and their mandates partly conflict. Among the agencies, the Federal Trade Commission (FTC) is unique in having consumer protection on the list of its primary mandates. We see several major

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shortcomings of the current regulatory framework. First, consumer protection has an "orphan" status, with no single agency being responsible for regulation and enforcement. Hence, consumer protection does not receive enough attention. Second, financial organizations could, by changing from one form of financial institution to another (e.g., from a bank charter to a thrift charter), pick the regulator and set of regulations they prefer to deal with. Third, most of these agencies do not have any litigation experience. The sole exception -- the FTC -- has only limited jurisdiction over financial institutions. Fourth, due to the distributed control, agencies have underinvested in the collection of information. Thus, we agree, that a unified federal consumer protection agency would be an improvement over the current system.

The House and the Senate both have proposals concerning the creation of an independent CFPA, which would report to Congress. This new agency would be charged with monitoring firms that offer financial services in order to protect the interests of consumers. The CFPA would unify the current regulatory framework without expanding the current legal framework, and consumer protection in many branches of the financial services industry would be subordinate to this single agency. The CFPA's mandate under both proposals would be to "ensure American consumers get the clear, accurate information they need to shop for mortgages, credit cards, and other financial products, while prohibiting hidden fees, abusive terms, and deceptive practices." [ii] The specific goals of the CFPA would include the following: to aid consumers in understanding and using relevant information; to protect them from abuse, deception, and fraud, by ensuring that disclosures for financial products are easy to understand; to conduct research; and to provide financial literacy education.

Both proposals assign three main responsibilities to the CFPA. First, the agency will have its own function for data collection and research that allows it to evaluate the appropriateness of financial products, and it is granted the power to acquire information to make competent decisions about regulation. Second, the CFPA would have the authority to set rules under current legislation. For example, the new agency can prescribe fiduciary obligations and operational procedures, but it is explicitly banned from imposing usury caps. Third, it would have a civil enforcement mandate that permits the agency to send investigators to financial service providers.

The primary differences between the current proposals in the House and the Senate are as follows:

(1) In the House bill, several branches of the personal finance sector are exempted from regulation, including financing provided by automobile dealers, smaller banks and credit unions (those with $10 billion or less in assets), mortgage, title, credit insurance, real estate brokers and agents, and most retail transactions involving credit. The Senate proposal does not currently include these exemptions.

(2) The Senate bill gives more enforcement power to states than does the House proposal. Specifically, the Senate bill would allow states to set tougher consumer standards than the federal law, and in this case, all firms would have to abide by state laws. In contrast, under the House bill, if the federal regulator of a national bank determines that state law places it at a competitive disadvantage, it would not have to meet the tougher state standards.

(3) The Senate bill proposes that the CFPA be run by a five-member board, four appointed by the President with recommendations from the Senate, and one of whom the President will select as Director. The House bill proposes that the CFPA be run by a director who is selected by the President and approved by the Senate. With the consent of the Senate, the President will select five additional members who are experts in consumer protection, fair lending and civil rights, representatives of depository institutions that primarily serve underserved communities, or representatives of communities that have been significantly affected by higher-priced mortgage loans.

Evaluation of Current Proposals

In evaluating the proposed legislation, two models are particularly helpful: the FTC's Bureau of Consumer Protection and the Financial Consumer Agency of Canada. The FTC's Division of Financial Practices under the Bureau of Consumer Protection has the mandate to protect "consumers from deceptive and unfair practices in the financial services industry, including protecting consumers from predatory or discriminatory lending practices, as well as deceptive or unfair loan servicing, debt collection, and credit counseling or other debt assistance practices." [iii] While the FTC's goals and methods are well-suited for providing consumer protection and financial education, its authority is limited to credit market activities by nondepository institutions, and thus is inadequate for protecting consumers across the wide range of financial products they face. Under the current proposals, the CFPA would take over some of the FTC's consumer financial protection responsibilities.

The Financial Consumer Agency of Canada supervises a broad range of financial service providers, including all banks, federally incorporated and registered insurance, trust and loan companies, and retail associations. Its mandate consists of consumer protection and consumer education and thus puts more emphasis on informing the public, compared with its U.S. counterpart. To enforce consumer protection laws, Canada's Financial Consumer Agency can seek a commitment from financial institutions to remedy issues in due time, impose monetary penalties or criminal sanctions, and take further actions if deemed necessary. Canada provided the Financial Consumer Agency with a research arm that also gathers data. This function makes information available to the public -- for example, databases on the rates and features of credit cards. Furthermore, the agency offers online quizzes that allow consumers to test their knowledge of credit cards and mortgages.

We endorse the creation of a consumer protection agency in the United States. While we are concerned that if not done effectively, there is risk of overregulation, we agree with the mission to unify enforcement for consumer protection. However, we strongly suggest several changes to the proposed bills.

Our first proposal concerns the scope of authority given to the CFPA. In particular, the House's proposal excludes regulation of several branches of the financial sector, such as realtors, automobile dealers, tax accountants, and retirement accounts. This carve-out from the direct oversight authority leaves a large part of consumers' assets underregulated. Worse yet, financial firms can exploit these loopholes in the CFPA's design by engaging in regulatory arbitrage. For instance, financial firms can redirect their credit supply to less regulated sectors. We therefore recommend the removal of most of these carve-outs.

Many consumers are not sufficiently financially literate to assess complex financial products and might make misguided decisions. We agree with the proposed bill that the CFPA should have a broad mandate for financial consumer education and information provision. The CFPA could, for instance, publish consumer guidelines, compare standard rates or contracts, and offer "financial literacy tests." However, as research demonstrates that financial education may not be enough to protect all consumers from poor choices, we believe that more is needed.

To aid those consumers for whom financial education does not suffice, the CFPA can actively intervene to improve overall welfare. We recommend that the CFPA should have the option of requiring financial service providers to include a "plain vanilla" product in their menu. This offering should be easy to understand, even for the inexperienced customer. It would also serve the purpose of a "point of reference" in comparison with other products. The CFPA should also ensure that default options are prudently chosen, since consumers, especially those who are inexperienced, are likely to refrain from active choices. In addition, the agency could consider marking certain products with a "seal of approval." Uninformed customers would thus be given the chance to fall back on financial products that have been scrutinized by the CFPA and about which they can get independent information. The proposed bill should endow the CFPA with the authority and the mandate to implement such actions.

Potentially harmful products might require additional measures. We suggest that the CFPA assist customers with litigation in cases of abuse, deception or fraud. As a last resort, we also endorse the CFPA's right to prohibit the sale of financial products or practices. However, no product should be banned before it has been tried by the market. Bans should only be imposed if consumer litigation and extensive market research have proven that the products or services are widely misused and detrimental to consumers. This proviso aims at curbing the danger of overregulation, which might leave some market participants worse off and might stifle financial innovation.

Lastly, the CFPA should focus not only on protecting consumers from misguided decisions, but also on improving the incentives of their brokers. To ensure good quality of financial advice, we propose that the CFPA should review the licensing practices for brokers and set minimum standards. Furthermore, the CFPA should be given the authority to review and regulate brokers' compensation. For instance, it could require broker fees to be paid out over time and to be partially dependent on the continued performance of the product. Such measures may help to ensure that consumers receive the sound advice they need to make prudent long-term financial decisions.