

THE CONSUMER FINANCIAL PROTECTION AGENCY

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The proposed Consumer Financial Protection Agency is premised on a fundamental misunderstanding of the causes of the financial crisis. Certainly there was fraud and abuse, from lenders and borrowers alike, during the housing boom which led to subsequent problems, as well as consumers who misunderstood their lending products. However, there is no evidence that the financial crisis was spawned by a systematic lack of understanding by consumers of the loans into which they were entering. Defaults and foreclosures increased due to misaligned incentives and rational consumer response to those incentives.

RESEARCH FINDINGS

- **The purpose and stated goals of the Consumer Financial Protection Agency represent a misdiagnosis of the causes of the crisis.** Consumers responded to misaligned incentives. Defaults and foreclosures became prevalent when interest rates rose, housing prices plummeted, and homeowners found themselves underwater with negative equity. Particularly, a foreclosure epidemic exists only in a handful of areas, specifically Las Vegas, Phoenix, Miami, and the Inland Empire region of California. These areas saw rampant speculation that produced price bubbles that have now popped, leaving many housing investors and homeowners with the incentive to foreclose.
- **Traditional American loans are neither safe nor risk-free.** The proposed CFPA aims at elevating the status of “plain-vanilla” mortgages and credit cards. First, it is unlikely that the CFPA could adequately determine what the best and most simplistic financial products are. Second, the premise that certain lending products can be classified as “risky” to borrowers, while others are not, is incorrect. Traditional American mortgages do have risks, such as inflation premiums and potential forgone returns. Also, if such loans were the best option for most consumers, other countries would have adopted them.
- **Adjusted-rate mortgages are not unreasonably dangerous.** While it is true that the initial surge of foreclosures for both prime and subprime mortgages were a manifestation of adjusted-rate mortgages (ARMs), it is faulty to conclude that all ARMs impose extreme risk. The mix of adjusted- and fixed-rate mortgages fluctuate throughout time. As spreads between the two rates increase, data shows that consumers choose to switch to ARMs. It is also true that virtually all mortgages in Europe are ARMs.
- **Erratic Federal Reserve monetary policy compounded the problem.** Inconsistent and unpredictable monetary policy—first holding short-term interest rates low then rapidly increasing them—further contributed to a problem with ARMs. Such actions posed problems in determining the actual spread between adjustable and fixed interest rate mortgages. The proposed CFPA appears to have no authority to keep Federal Reserve policy stable.

- **Current regulations further increase uncertainty and misalign incentives.** Anti-deficiency or “non-recourse” lending laws, found in numerous states, limit the lenders’ ability to sue a borrower for remaining deficiencies after default. Empirical evidence indicates that foreclosure default and foreclosure rates are higher where there are anti-deficiency laws. Such laws, in correspondence with various financial terms and products, create incentives for consumers to walk away from underwater mortgages, creating a safety and soundness issue, not a consumer protection issue.
- **The variety of credit cards available on the market represents consumer understanding and demand, as well as the existence of competition and the ability to innovate.** Most consumers are satisfied with their credit cards and understand their terms. Consumers also tend to shop around before making a decision. They are not passive sheep timidly waiting to be shorn. By promoting simplicity, the CFPA would stifle competition and innovation while falsely assuming consumer ignorance.
- **The proposal to ban or discourage prepayment penalties and “yield spread premiums,” as well as other actions by the CFPA, will cause unintended consequences.** There is overwhelming economic evidence supporting prepayment premiums, which exist to compensate lenders for the risk of having to reinvest funds at lower market interest rates when interest rates fall. Loans without such a premium have higher fees, increasing the initial cost of the loan, and may lead to more refinancing activity and further equity depletion. Yield spread premiums, incurred by mortgage brokers, are the difference between wholesale and retail costs of funds. While mortgage brokers do have an incentive to increase this spread, and therefore their profit, they are also in competition with other brokers to obtain and retain borrowers (an incentive to competitively lower rates). Such incentives balance out. This balance is in jeopardy of misalignment if the CFPA restricts mortgage brokers.
- **Additionally, low-documentation loans can be reasonable financial products in some cases.** A borrower with a high credit score, a long track-record of timely payment, and equity in his home could find that a lower interest rate without the substantial cost, delay, and inconvenience of a full-blown refinancing process. In contrast, such a loan would not make sense for a purchase-money loan for a new borrower with no equity in his home.
- **The creation of the CFPA will result in knowledge problems, bureaucratic turf battles, and continual desire to expand regulatory boundaries over improved function.** Financial products cannot be dissected into individual parts in order to determine the risks and causes of problems, but must be looked at as a whole. Studies show that most consumers do not understand all the risks associated with their mortgages, automobiles, computers, medical and legal services, and other products. Yet, even when consumers lack knowledge, most find that these products work well. There is no evidence that a government agency could do better through regulatory analysis. Additionally, current agencies, such as the Federal Trade Commission and Federal Reserve have consumer protection, safety, and soundness authority. Instituting the CFPA will only complicate the power and scope of government with the unintended consequence of limiting consumer choice.

OPPORTUNITIES FOR CHANGE

- **The proposed Consumer Financial Protection Agency should be rejected.** The potential agency is based upon faulty foundations, which lack proper evidence, regarding the causes of the financial crisis. Adjustments or tweaks to the CFPA proposal will not improve the results or eliminate the unintended consequences.
- **Instead, policymakers should focus on other agencies and policies which are better suited for the current financial and regulatory environment.** Such areas include:

- Potential expansion of the jurisdiction of the Federal Trade Commission and strengthening of the Federal Reserve to meet the discrete categories of true consumer protection issues that arise under current law.
- A review and possible implementation of the recommendations for improving consumer disclosures in a more user-friendly manner found within a Federal Trade Commission study on consumer disclosure regulations.
- Prospective reform on the tax structures and other incentives that encourage overinvestment or foreclosures in housing.

RECENT RESEARCH BY TODD ZYWICKI ON THE CONSUMER FINANCIAL PROTECTION AGENCY

“[Testimony on the Consumer Financial Protection Agency: Banking Industry Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals](#),” Congressional Testimony, United States House of Representatives Committee on Financial Services, July 15, 2009.

“Loans Are Not Toasters: The Problems with a Consumer Financial Products Safety Commission,” *Mercatus on Policy*, forthcoming.

TODD ZYWICKI IN THE NEWS ON THE CONSUMER FINANCIAL PROTECTION AGENCY

“[Let’s Treat Borrowers Like Adults: The problems with a financial products safety panel](#),” *Wall Street Journal*, July 8, 2009. Discusses the proposal for the Consumer Financial Protection Agency and its problems.

ABOUT TODD ZYWICKI



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