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THE CONSUMER FINANCIAL PROTECTION BUREAU: Savior or Menace?

By Todd J. Zywicki

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George Mason University

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TODD J. ZYWICKI
GMU Foundation Professor of Law, George Mason University School of Law
Senior Scholar, Mercatus Center

Abstract:

One of the centerpieces of the Dodd-Frank financial reform legislation was the creation of a new federal Consumer Financial Protection Bureau of the Federal Reserve. Few bureaucratic agencies in American history, if any, have combined the simultaneous degree of vast, vaguely defined power and lack of public accountability of the new bureau. It is an independent agency *inside* another independent agency (the Federal Reserve). It is presided over by a single director (rather than a multi-member commission structure) appointed for a term of five years and insulated from removal by the President. It has a guaranteed budget drawn directly from the Federal Reserve and is thus outside Congress's appropriations process. Its actions are unreviewable by the Federal Reserve and can be checked bureaucratically only by a supermajority vote of the Financial Stability Oversight Commission (FSOC) and only if its actions would imperil the safety and soundness of the American financial services industry.

Proponents of the new agency argue that this extreme level of independence is justified in order to provide the new bureau with insulation from political pressures. But the history of regulation has taught that insulation can be isolation, resulting in rudderless and inefficient regulation. In addition, over the past several decades, scholars of regulation have identified a number of common pathologies associated with bureaucratic behavior. Astonishingly, the CFPB is structured in such a manner that it virtually guarantees the manifestation of those bureaucratic pathologies in practice: excessive risk-aversion, agency imperialism, and agency tunnel vision. Indeed, it is as if the CFPB were an agency frozen in amber during the Nixon administration and thawed out today, completely unaware of the lessons of the past several decades on how to structure an effective and efficient regulatory strategy.

In the end, by manifesting these bureaucratic pathologies, the CFPB is likely to raise the price and reduce access to credit, thereby harming the very consumers it was founded to protect.

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A centerpiece of the Dodd-Frank financial system reform legislation was the creation of the new Consumer Financial Protection Bureau (CFPB) of the Federal Reserve. Indeed, so high profile was the agency that it catapulted its first leader, Elizabeth Warren, onto the political stage.

To be sure, the system of consumer financial protection needed streamlining and reform even before the onset of the financial crisis. A patchwork of different agencies covered different aspects of the financial system, and all of them tended to focus on safety and soundness issues rather than consumer protection. The most obvious federal regulator, the Federal Trade Commission (FTC), was prohibited from exercising authority over most of the industry, having jurisdiction over only non-bank lenders. Into this regulatory gap poured politically ambitious state attorneys general and state legislatures, suing and legislating with an eye toward buying in-state votes with the money of out-of-state banks and balkanizing the consumer banking system, which subsequently triggered a reprisal by the federal government using its preemption power. On the federal level, the simplicity and coherence of the original Truth and Lending Act had been eroded by decades of class action lawsuits and regulatory sedimentation rendering the system increasingly unworkable and incoherent. The original model of disclosure-based regulation had been confused and modified by meddling as the federal government increasingly gravitated toward mandating what it thought consumers should care about rather than what they do care about. Thus, the need for reform was urgent and the opportunity ripe.

Alas, the creation of the CFPB squandered this historical opportunity for innovative and effective consumer protection reform. Although touted as a great leap forward for consumer protection, the institutional design of the CFPB is in fact a great leap backward into the principles that animated agency design in the New Deal and post-New Deal era—but which were abandoned in the 1970s in a bipartisan effort to rectify their deleterious effect on the American economy. If one were to sit down and try to design a policy-making agency that essentially embodied all the pathologies that scholars of regulation have identified over the past several decades, one could hardly do better than that of the CFPB: an unaccountable body headed by a single director insulated from removal by the president or budgetary oversight by Congress and charged with a tunnel-vision mission to pursue one narrow goal with potential for substantial harm to the economy and consumers. So flawed is the CFPB's design and so similar is it to the regulatory agencies of an earlier era that the problems it will manifest and the harm it will impose on the economy are entirely predictable—and, based on its early efforts, it is manifesting that harm already. Most tragically, unless reformed, the likely result of the CFPB in operation will be a result completely contrary to that intended by its founders—resulting in an increase in fraud against consumers, an increase in foreclosures in the event of a future market downturn, and an increase in cost and reduction of access to high-quality credit products for consumers. This article is an effort to avert those harms by pointing out these structural defects in the hope that the agency will be reformed before those harms materialize.

This article thus begins by briefly reviewing the historical evolution of the CFPB and placing it in the context of the history of the regulation of consumer credit and study of the theory of regulation in the twentieth century. The article then describes some of the novel structural features of the agency, drawing on the literature of agency to design to illustrate why the novel features of the CFPB are undesirable. It will then turn to the incredibly broad and ill-defined grant of powers to the CFPB, focusing in particular on its power to attack “abusive” loan products and terms. Third, the article will discuss the incoherence of the statutory scheme that has been created regarding preemption of contrary state laws. It then will address an unexamined proposition that lies at the root of the Dodd-Frank legislation generally and the consumer protection provisions of the statute specifically: the now commonly accepted but troubling assumption that it is appropriate for the government to pick and choose market winners and losers with no coherent justification, rather than creating a level playing field of equally applicable and neutral rules that structure the market process rather than proving advantages or disadvantages to some market participants or products. Finally, the article will briefly discuss some possible reforms to the CFPB that would mitigate some of its most undesirable features.

I. The Short History of the CFPB

The origins of the CFPB lie in a short article authored by Professor Elizabeth Warren in 2007 in which she proposed a new consumer financial protection agency modeled on the Consumer Protection Agency, which regulates the safety of consumer products.[2] Leaving aside the illogical nature of the analogy between consumer appliances and consumer credit,[3] the article seeded the ground for the opportunity created a few

[2] See Elizabeth Warren, “Unsafe at Any Rate,” *Democracy Journal*, Summer 2007, no. 5, available at http://www.democracyjournal.org/article.php?ID=6528.
[3] See Stefanie Haeffle-Balch & Todd J. Zywicki, “Loans Are Not Toasters: The Problems with a Consumer Financial Protection Agency,” *Mercatus on Policy* No. 60 (October 2009) (noting that unlike unsafe consumer products such as toasters almost all consumer credit products are useful for some consumers in some contexts).

years later when Barak Obama was elected president in the midst of the financial crisis. At that point, the new financial consumer protection agency was touted as a centerpiece of the Obama administration's reform efforts in the wake of the financial crisis.

In 2009 the Obama administration published a "white paper" that laid out the framework that later became the basis for the Dodd-Frank financial reform legislation, including a new consumer financial protection agency. As originally proposed, the new agency was modeled on the federal Consumer Protection Agency, being a multi-member commission funded by appropriations. As originally introduced by Barney Frank in the House of Representatives in July 2009, the agency retained a multi-member commission structure but also added an independent revenue stream.[4] The proposal for a new agency, however, drew widespread criticism, especially from Republicans. In response to this criticism, the proposal was made to instead turn the proposed agency into a bureau of the Federal Reserve.[5] When legislation was introduced in the Senate by Senator Christopher Dodd in April 2010, therefore, the new consumer agency had been converted into a bureau of the Fed, with a single director and an independent revenue stream. Eventually, the Dodd-Frank financial reform legislation passed Congress and was signed into law July 2010.

The concept of a new dedicated consumer financial protection agency was one of the centerpieces of the Obama financial regulatory reform program. To a large extent, the critique of the existing consumer financial protection system at the federal level was well-founded: Consumer financial protection was balkanized among many disparate bank

[4] H.R. 4173, 111th Cong. (2009) (enacted).
[5] See, e.g., Andrew Martin and Louise Story, "Banks Brace for Fight over an Agency Meant to Bolster Consumer Protection," *New York Times* (June 17, 2009), http://www.nytimes.com/2009/06/18/business/18consumer.html?ref=consumerfinancialprotectionbureau.

regulation agencies, none of which had particular expertise in consumer protection regulation (as opposed to prudential regulation). Issuance of new rules regarding consumer protection often resembled a United Nations meeting: a fractious, multi-agency negotiation process animated as much by bureaucratic turf battles and warring agency cultures as promoting a rational and efficient consumer protection policy. Moreover, the need for reform of consumer protection laws at the national level predated and was independent of the financial crisis that finally provided the impetus for reform. Many of the new financial services providers swept under the CFPB's umbrella had nothing at all to do with the financial crisis at all, such as payday lenders and providers of cash remittances. That there is absolutely no evidence that failures in consumer protection actually contributed in a major way to the crisis does not detract from the fact that greater coherence and rationalization was needed. Concentrating consumer financial protection in one body was a reasonable reform to this system; on the other hand, the responsibilities given to the CFPB could have been allocated to the already-extant FTC, which already had deep expertise in consumer protection issues, including certain elements of consumer financial products. Thus, the fact that it was unnecessary to create a new super-agency (the CFPB) to perform the task should not be read as suggesting that institution reform of the consumer financial system was unnecessary.

Almost from the beginning, the new bureau proved to be politically controversial. It was conventionally believed that the first director of the Bureau would be its intellectual godmother, Elizabeth Warren. Warren, however, soon found herself too politically controversial to be confirmed to the agency. As a result, rather than nominating her to head the Bureau, President Obama instead named her as an assistant to the president and special advisor to the secretary of the Treasury on the Consumer Financial Protection Bureau. In this position, Warren was tasked with the responsibility of setting up the Bureau and preparing it for action when it became effective, which was one year following the passage of Dodd-Frank (as provided by a Treasury notice pursuant to the statute).[6] At the end of that one year period, however, it remained clear that Warren could not be confirmed. Moreover, Warren had decided in the meantime to run for the Democratic nomination for the U.S. Senate from Massachusetts, challenging incumbent Scott Brown. As a result, she was never nominated by the White House to head the Bureau.

Instead, on July 18, 2011, President Obama nominated former Ohio Democratic Attorney General Richard Cordray to serve as CFPB director. Senate Republicans immediately announced that they would filibuster any vote on confirmation of Cordray's nomination until certain structural reforms were made to the Commission.[7] These conditions insisted on by the Republicans included reforming the CFPB into a multi-member bipartisan agency (rather than one with a single director), bringing the CFPB under Congress's appropriations authority, and reducing the required level of consensus for the Financial Stability Oversight Commission (FSOC) to overrule actions by the CFPB from two-thirds consensus (as required by Dodd-Frank) to a simple majority. The Obama administration refused to acquiesce to this request, thus the position remained vacant.

[6] See "Designated Transfer Date," 75 *Federal Register*, 57252 (September 20, 2010) (issued pursuant to 12 U.S.C. § 5582(a)(2) (West 2012) (setting the transfer date as July 21, 2011, exactly one year after the passage of Dodd-Frank).
[7] See Richard Shelby, "The Danger of an Unaccountable 'Consumer-Protection' Czar," op-ed, *Wall Street Journal*, July 11, 2011, available at http://online.wsj.com/article/SB10001424053111903554904576457931310814462.html.

Then, in a surprise move on January 4, 2012, President Obama took the unprecedented step of naming Cordray the director of the Bureau, claiming that the president could do so under his power to make recess appointments, even though Congress was not actually in recess. The legality of Cordray's status remains unclear and has been challenged in a lawsuit that challenges a variety of provisions of the CFPB and Dodd-Frank generally. Moreover, the issue is important not just because of the constitutional issues implicated but also because the statute itself makes the transfer of certain new powers granted to the CFPB under the statute (namely, the power to regulate non-bank lenders such as payday lenders as well as credit reporting agencies) subject to the presence of a "confirmed director." In addition, the term "confirmed director" is a defined term in the statute, seemingly requiring someone who has been nominated and confirmed subject to the advice and consent of the Senate.[8] Thus, even if Cordray's appointment is constitutionally valid (despite the apparent lack of a congressional recess that would justify a recess appointment), it remains an open question as to whether a recess appointment without formal confirmation satisfies the *statutory* requirement that the CFPB have a "confirmed director" for it to acquire the full scope of its powers under the law.

II. Consumer Credit Regulation and Regulatory Theory in American History

The modern regulatory framework for the regulation of consumer credit—until the 2008 financial crisis and the rise of the Obama-Warren regulatory

[8] 12 USCA § 5491 (b)(2) (West 2012). "[T]he Director shall be appointed by the President, by and with the advice and consent of the Senate."

counterrevolution—was forged by the experience of the economic crisis of the 1970s and an academic backlash against regulatory framework constructed during the New Deal.

The lessons learned had two mutually reinforcing elements. First, it grew out of decades of learning regarding the unintended consequences of poorly conceived regulation of consumer credit. Second, it grew out of an improved understanding of the pathologies and tendencies inherent in bureaucratic decision making and a need for institutions that could counterbalance those tendencies. A full accounting of both of these historical lessons is beyond the scope of this article, but an understanding of these twin historical phenomena and why they produced particular theories of regulatory theory and consumer credit regulation is necessary to understand the radical intellectual counterrevolution embodied in the CFPB.

A. Consumer Credit Regulation: The Lessons of History

In pre-Civil War America, most Americans were farmers, living outside major population centers. Gold and silver coins were scarce. Personal credit, however, was not, and farmers relied on credit to smooth investment and consumption across the crop harvesting season. Credit was as important as the Conestoga Wagon in conquering the West.[9]

In the decades following the Civil War, a tide of immigrants swept into America, building the great cities. Most urban dwellers were unskilled blue-collar workers with unpredictable employment and income, thus the consumer credit industry emerged to cope with seasonal fluctuations in employment. This need for unsecured, small-loan seasonal borrowing placed new pressures on the consumer credit system and regulation.

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[9] Lewis Mandell, *The Credit Card Industry: A History*, xii (1990).

In post-Civil War New York City, for instance, two-thirds of the city's total consumer lending came from small-loan agencies, including loan sharks and forerunners to today's and "payday" or "wage assignment" lenders.[10] Pawn shops proliferated—in some neighborhoods, virtually the entire population had a pawn ticket at all times and as many as twelve in the winter when factories typically closed down.[11] These various unlicensed lenders charged interest rates that approached 300 percent annually and resorted to embarrassing and aggressive collection practices to enforce repayment of these illegal debts.[12]

Counterproductive usury regulations made operations unprofitable for legitimate lenders to operate, thereby driving many urban consumers into the hands of illegal lenders.[13] It was estimated that, in 1911, 35 percent of New York City's employees owed money to illegal loan sharks.[14] Reviewing the credit market of this era, former Federal Reserve Chairman Alan Greenspan has described the plight of lower-income wage earners subject to aggressive and overreaching creditors as one of "virtual serfdom."[15]

Confronted with these dual problems of an increased need for consumer credit by an urbanized wage-earner economy and an outmoded moralistic and paternalistic system of consumer credit regulation, reformers began to search for progressive solutions, especially to the recurrent problem of illegal loan sharks arising to serve the needs of wage-earners unable to obtain credit elsewhere. Beginning in the early twentieth century,

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[10] Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit* 49–50 (1999).
[11] *Id.* at 44–48.
[12] See *id.* at 48–54. Interest rates on these loans were comparable to modern payday lenders. Collection practices by illegal loan sharks were much more severe, of course.
[13] Alan Greenspan, "Remarks, Economic Development Conference of the Greenlining Institute" (October 11, 1997), available at http://www.federalreserve.gov/BoardDocs/Speeches/1997/19971011.htm (hereinafter Greenspan, "Greenlining Remarks").
[14] Calder, *supra* note 10, at 118.
[15] Greenspan, "Greenlining Remarks," *supra* note 13.

far-sighted reformers and consumer advocates associated with the non-profit Russell Sage Foundation began to push for reforms to consumer credit laws, sponsoring path-breaking economic research on consumer credit that highlighted the negative unintended consequences associated with overly strict and outmoded consumer credit laws. Its efforts culminated in the first Uniform Small Loan Law in 1914, which recognized the need for consumer credit and sought to bring it out of the hands of loan sharks and into competitive markets.[16] In subsequent decades, access to consumer credit grew rapidly, especially consumer installment lending and early automobile installment credit.

These beneficial regulatory developments, however, came to a crashing halt in the wake of the Great Depression. A common explanation of the Great Depression is that it was caused in part by an excess of consumer credit, especially installment lending to purchase consumer durables such as appliances and automobiles.[17] The response was a backlash in the form of tight restrictions on access to consumer credit—interest rate ceilings were ratcheted downward and new regulatory barriers to the entry of personal finance companies and small-loan lenders were erected. Consumer credit markets were balkanized by a complex web of regulations that treated functionally similar credit products disparately based on loan size, interest rates, and other characteristics, which stifled competition and resulted in higher prices for consumers. Moreover, this regulatory web also had the effect of generating market winners and losers, intentionally or unintentionally favoring some types of lenders over others (such as retailers over non-retailers, larger retailers over smaller ones, and pawn shops over unsecured lenders) and certain types of consumers over others (such as middle class and wealthy consumers over

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[16] Thomas A. Durkin, Gregory Elliehausen, Michael Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy* (2010).
[17] See Durkin, Elliehausen, Staten, and Zywicki, *supra* note 16.

lower-income consumers).[18] Most notably, by the 1960s and 1970s, illegal loan-sharking had returned with a vengeance as loan sharks rushed in to fill the gaps created by regulations that effectively excluded many consumers from legitimate credit markets entirely. Indeed, in 1969, famed liberal economist Paul Samuelson went before the Massachusetts State Legislature to plead for a relaxation of the state's usury ceilings on the ground that a primary beneficiary of usury ceilings was organized crime, not consumers.[19]

This increasing and bipartisan consensus regarding the harmful effects of misguided regulation of the terms and conditions of consumer credit led in turn to a new approach to consumer credit regulation similar to that adopted earlier in the century. In particular, rather than using regulation to dictate substantive terms of consumer credit that attempted to displace market terms (such as interest rates and loan size), economically sophisticated reformers came to see that it would be more productive to instead attempt to accept the necessity of market forces and seek to make them work better for the benefit of consumers. The new approach focused on promoting competition and consumer choice in markets with a regulatory approach focused on disclosure-based regulation designed to promote these competitive market forces. The result was important regulation of the era such as the Truth in Lending Act, which abandoned old-style imposition of terms and instead sought to construct standardized disclosure formats, which in turn would enable consumers to compare more easily the terms and conditions of competing offers. But this revolution reflected more than just a change in economic

[18] Todd J. Zywicki, "The Economics of Credit Cards," 3 *Chapman Law Review*, 79 (2000).
[19] Statement by Dr. Paul A. Samuelson before the Committee of the Judiciary of the General Court of Massachusetts in Support of the Uniform Consumer Credit Code January 29, 1969. Chicago, Illinois: National Conference of Commissioners on Uniform State Laws, press of George H. Dean Co. (Boston).

thinking—the change was intellectual as well, reflecting an abandonment of the paternalistic philosophy of political elitists who felt that the mass of consumers could not be trusted with access to consumer credit. These regulatory elitists were especially vigilant to protect groups that they saw as vulnerable—the poor, immigrants, and perhaps most of all women, whom paternalists viewed as especially needing protection because of their poor math skills.[20] The deregulatory reforms that began in the 1970s, by contrast, were grounded on the dual premises of treating borrowers like adults (even supposedly math-impaired females) and awareness of the demonstrated inability of governmental regulators to improve matters by substantive regulation into consumer credit markets.

The second major regulatory transformation during this period was the Supreme Court's decision in *Marquette National Bank* in 1978, which held that, for purposes of choice of law of consumer interest rates, the relevant state would be the state of the issuing bank rather than the state of the consumer's residence.[21] The effect of this decision was profound—by allowing the "exportation" of interest rates on consumer credit, *Marquette* prompted the growth of a fully nationalized consumer lending market that brought those efficiencies to consumers. More concretely, *Marquette* enabled the rapid growth of the credit card industry, setting in motion a robust competitive structure that resulted in the spread of credit cards throughout the economy and the displacement of many traditional types of credit that were more expensive, less flexible, and otherwise inferior to credit cards (such as layaway, retail store credit, and many types of personal finance companies and other high-cost lenders).

[20] Calder, *supra* note 10, at 166.
[21] *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 313 (1978). "Since Omaha Bank and its BankAmericard program are 'located' in Nebraska, the plain language of [the National Banking Act] provides that the bank may charge 'on any loan' the rate 'allowed' by the State of Nebraska."

This hard-won intellectual consensus built up over several decades of learning about the benefits of access to high-quality consumer credit and the unintended consequences of bad regulation was smashed by the 2008 financial crisis. Ironically—and, to a large extent, predictably—the intellectual response to the financial crisis has to repeat the same arguments heard in prior eras regarding consumer credit and the link to macroeconomic instability, combined with a call for new paternalistic regulation (under the new guise of "behavioral economics" which is seen as providing new justification for paternalistic intervention into consumer credit markets[22]). But these current approaches not only ignore the lessons of history, but actually appear to be based on a fundamental *misunderstanding* of the lessons of history that incorrectly imagines a golden age of consumer credit. As will be explained below, the cost of this historical amnesia likely will be high—a repeat of the destructive regulatory philosophies of the past, with disastrous results for consumers and the economy, and especially low-income consumers and other vulnerable consumers with the fewest credit choices.

B. Bureaucratic Agency Design: The Lessons of History

A second strand of history is ignored by the architects of the CFPB, a strand that follows much of the same historical trajectory as the repudiation of the consumer credit regulatory apparatus constructed in the post-Depression era. This second strand relates to the history of the theory of regulation and the design of regulatory agencies and regulatory processes.

[22] See Joshua D. Wright and Todd J. Zywicki, "Three Problematic Truths about the Consumer Financial Protection Agency Act of 2009," *1 Lombard Street*, no. 12, Sep. 15, 2009, at 8–13.

Beginning in the Progressive Era and reaching its apotheosis during the New Deal, a new type of regulatory approach came into vogue. Impressed by the increasing complexity of society and frustrated by the supposedly dysfunctional nature of electoral politics, the New Deal created an armada of expert regulatory agencies staffed by expert decision-makers and tasked with the responsibility of bringing expertise to bear to design regulatory policies. These experts were by design to be insulated from market and political pressures so that they could be free to pursue the "public interest." As they understood it, their decision making would be uncorrupted by venal self-interested influences.[23]

By the 1970s, however, this naïve model of governmental decision making was falling into deep disrepute. The increasing economic burden imposed by bureaucratic regulation was seen as reducing economic growth, stifling innovation, increasing inflation, and undermining America's global competitiveness. Much of the blame came to rest on the philosophy that had animated the New Deal support for administrative agencies—the naïve view that unelected bureaucrats insulated from political oversight and other feedback mechanisms would produce ideal policies.

Instead, scholars of regulation came to observe that responsive public oversight of bureaucratic action could provide a salutary check on bureaucratic decision making by providing information about the social and economic consequences of their policy choices. While insulation from oversight provided independence, it also created isolation. At best, bureaucratic action is often irrational and dysfunctional.[24] At worse, it is often subject to capture by interest groups and repeat players, whether industry interest groups

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[23] See Maxwell Stearns and Todd J. Zywicki, *Public Choice Concepts and Applications in Law* 44–46 (2009) (discussing the "public interest" theory of regulation).
24 See Stephen Breyer, *Breaking the Vicious Circle: Toward Effective Risk Regulation,* 10–19 (1993).

or non-profit non-governmental entities that receive benefits from them and provide staffers for the agencies. It was also recognized that the decentralized growth of the regulatory state required increased coordination of regulatory policy within the executive branch. One important response was the creation of the Office of Information and Regulatory Affairs, which was tasked with the mission of creating coherence among the conflicting directives of different regulatory agencies and balancing regulations so as to preserve other values such as economic growth and national security.[25] Finally, beginning in the 1970s, analysts began to explore the internal dynamics of regulatory agencies to identify the sources of the pathologies that had resulted in the counterproductive and economically destructive policies in the 1970s.[26]

The outcome of the painful lessons learned during the stagflation and declining American competitiveness of the 1970s was a bipartisan effort to dramatically restructure governmental agencies to make them more responsive and more resistant to the regulatory pathologies that had been identified. Several old agencies that were seen as outmoded, such as the Interstate Commerce Commission and Civil Aeronautics Board, were simply abolished. Other dysfunctional agencies were reformed by a combination of aggressive congressional oversight and conscious efforts to improve their operations, such as the FTC.[27] The end result was a more balanced regulatory policy that sought to re-impose checks and balances on the regulatory process by counterbalancing the tendency for bureaucracies to manifest certain predictable pathologies and to bring more collaborative decision making to regulatory process.

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[25] See Stearns and Zywicki, *supra* note 23, at 366–67 (discussing OIRA).
[26] See, e.g., William A. Niskanen, Jr., *Bureaucracy and Representative Government* (1971); James Q. Wilson, *Bureaucracy: What Government Agencies Do and Why They Do It* (1989).
[27] See Richard A. Harris and Sydney M. Milkis, *The Politics of Regulatory Change: A Tale of Two Agencies* (2nd ed. 1996).

Again, as will be detailed below, the institutional structure of the CFPB fundamentally ignores these important historical lessons. It creates a single-mission agency insulated from budgetary oversight, OIRA review, and effective oversight of its decisions. As such, it is a virtual poster child for an agency design that eventually will be likely to manifest the bureaucratic pathologies that led to the disastrous regulatory policies that were abandoned in the 1970s. It is as if the agency was frozen in amber during the Nixon administration and then thawed out in 2008, completely unaware of the dramatic improvements in the understanding of regulatory policy in the intervening decades.

III. Structural Defects of the CFPB

Analyzing the historical arch of the twentieth century regulatory state, scholars of regulation have identified a number of bureaucratic pathologies that explain the unresponsive and counterproductive regulation that evolved in the United States, as well as providing suggestions on how to construct regulatory agencies in order to avoid these foreseeable problems. Instead, the CFPB erects a regulatory structure that is oblivious to these lessons, laying the foundation for a repeat of the bureaucratic stagnation that culminated in the 1970s and was swept aside after these lessons were absorbed. Unfortunately, the architects of the CFPB—seemingly oblivious to this history—stand poised to repeat those errors again, with potentially disastrous consequences for consumers and the economy.

The CFPB has several features that distinguish it from most other governmental agencies. First, the CFPB is exempted from the congressional budgetary and appropriations process. Instead, the CFPB receives from the Federal Reserve the "amount determined by the [CFPB] Director to be reasonably necessary" subject to a 10 percent cap of the Federal Reserve's total operating expenses in 2011, 11 percent in 2012, and 12 percent in 2013 and each year thereafter.[28] Mandatory 2011 appropriations were $162 million in 2011, and then rise rapidly as estimated 2012 mandatory appropriations climbed to $340 million; estimated 2013 mandatory appropriations have more than doubled the 2011 figure, reaching $448 million.[29] In addition, the CFPB is entitled to request still further funds from the Federal Reserve under certain circumstances.[30] Thus, not only does Congress have no real budgetary oversight authority over the CFPB through its appropriations responsibility, the Fed itself essentially has no ongoing budgetary oversight authority either.

Second, the CFPB is headed by a single director appointed for a fixed term of five years and removable only for "cause," defined as "inefficiency, neglect of duty, or malfeasance in office."[31] Although many departments and agencies are headed by single heads, most of them serve at the pleasure of the president and are removable by the president (such as cabinet secretaries). Independent agencies typically are headed by multi-member commissions whose members serve for fixed terms and are removable only for cause. In the rare instances where single directors serve as heads of agencies with formal *de jure* protection from removal, such as the comptroller of the currency, it

[28] 12 USCA § 5497(1)-(2) (West 2012).
[29] Office of Mgmt. and Budget, *Consumer Financial Protection Bureau*, FY 2013 Other Independent Agencies 1295 (2012), available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/oia.pdf.
[30] See 12 U.S.C. § 5497(e)(1)(B)(2) (West 2012) (authorizing CFPB to request up to $200 million in discretionary funds, subject to the congressional appropriations process).
[31] 12 USCA § 5491(c)(3) (West 2012).

appears that as a *de facto* matter such heads serve at the pleasure of the president.[32] Moreover, these single-director agencies usually do not hold broad policy-making responsibilities but instead are involved in expertise-based regulation, such as supervising the safety and soundness of banks or, as elsewhere in the government, the scientific process of the Food and Drug Administration (FDA). By contrast, the CFPB director has a huge policy-making function in controlling the flow and terms of consumer credit in the American economy—policies with massive policy implications.

Third, the decisions of the CFPB can be overridden only by a two-thirds vote of the Financial Stability Oversight Council (FSOC), a new entity created by Dodd-Frank to supervise the safety and soundness of the American financial system.[33] Moreover, the FSOC can veto actions by the CFPB only if they would seriously threaten the "safety and soundness of the United States banking system or [put] the stability of the financial system of the United States at risk."[34]

Finally, Dodd-Frank also expressly provides that for purposes of *Chevron* deference, which is discussed below, courts must defer to the CFPB regarding the

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[32] *Who's Watching the Watchmen? Oversight of the Consumer Financial Protection Bureau: Hearing before the H. Subcomm. on TARP, Financial Services, and Bailouts of Public and Private Programs*, 112th Cong. 83–84 (2011) (statement of Andrew Pincus, on behalf of the U.S. Chamber of Commerce).

[33] See 12 USCA § 5513(c)(3)(A) (West 2012). The FSOC is composed of ten voting members—nine federal financial regulatory agencies and an independent member with insurance expertise—and five nonvoting members. *See* 12 USCA § 5321(b)(1)-(2) (West 2012).

- Voting Members: The secretary of the Treasury, who serves as the chairperson of the FSOC, the chairman of the board of governors of the Federal Reserve System, the comptroller of the currency, the director of the Consumer Financial Protection Bureau, the chairperson of the Securities and Exchange Commission, the chairperson of the Federal Deposit Insurance Corporation, the chairperson of the Commodity Futures Trading Commission, the director of the Federal Housing Finance Agency, the chairperson of the National Credit Union Administration Board, and an independent member with insurance expertise that is appointed by the president and confirmed by the Senate for a six-year term. Id. at § 5321(b)(1).
- Nonvoting Members Who Serve in an Advisory Capacity: The director of the OFR, the director of the Federal Insurance Office, a state insurance commissioner selected by the state insurance commissioners, a state banking supervisor chosen by the state banking supervisors, and a state securities commissioner designated by the state securities supervisors. The state nonvoting members have two-year terms. Id. at § 5321(b)(2).

[34] 12 USCA § 5513(c)(3)(B)(ii) (West 2012).

meaning or interpretation of any provision of federal consumer financial law, thereby ensuring that the CFPB's interpretation will trump any contrary interpretation from the Federal Reserve itself or any other entity, as well as specifically limiting judicial review of the CFPB's interpretation of any statute.[35]

The effect of these interlocking provisions has been to make the CFPB one of the most powerful and publicly unaccountable agencies in American history. It is effectively an independent agency housed inside another independent agency—not only largely immune from congressional appropriations but from oversight by the Federal Reserve as well. Neither body can control the CFPB's budgetary appropriations. Moreover, there is no multi-member commission to counterbalance the Director's policy initiatives. Finally, substantive checks on the CFPB can be triggered only by satisfying the cumbersome supermajority rule threshold required for the FSOC to act and only under the extreme circumstances of a severe threat to the safety and soundness of the American financial system. It is likely that this extreme test will rarely be satisfied in practice.

In practice, therefore, the CFPB is an extremely independent agency—more so, perhaps, than any other agency before. Led by a single director with authority to engage in both rule making and litigation, immune from budgetary oversight, and largely insulated from substantive review, the agency has extreme independence to carry out its functions. Indeed, this extreme independence was originally touted as one of the Bureau's great virtues, as the purported lack of independence of prior financial regulators had been

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[35] 12 USCA § 5512(b)(4)(B) (West 2012). "[T]he deference that a court affords to the Bureau with respect to a determination by the Bureau regarding the meaning or interpretation of any provision of a Federal consumer financial law shall be applied as if the Bureau were the only agency authorized to apply, enforce, interpret, or administer the provisions of such Federal consumer financial law."

thought to have been a source of the allegedly lax oversight that produced the financial crisis.

A. Characteristics of Agency Behavior

Scholars of regulation have identified a number of tendencies to which bureaucracies are subject. Several are particularly relevant in understanding the flaws in the CFPB's institutional design: a tunnel-vision selection bias and commitment to regulatory mission, systematic risk-averse bias in agency decision making, a tendency toward agency overreach and expansionism, and a heightened risk of regulatory capture by industry participants. Each of these problems are exacerbated in the case of the CFPB by its self-proclaimed "single focus" on consumer protection, narrowly defined. Each of these problems is further exacerbated by the single-director structure of the CFPB, which makes it unusually vulnerable to idiosyncratic decision making by the head of the organization. The problems arising from this single-director structure are especially concerning if that organization head is tainted by narrow partisan political ambition, as is the case with its first two leaders: Elizabeth Warren, who used the agency as a launching pad for political ambition, and Richard Cordray, a former politician who may have future political aspirations.[36]

One characteristic of agency decision making is a tendency toward a tunnel-vision focus on the agency's regulatory mission at the expense of other policy goals.[37] Forty

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[36] Of course, there is nothing wrong with partisan politicians or those with political aspirations serving in agency functions. The difference between the CFPB and other agencies, however, is that the CFPB has been billed as non-political in nature, which is the justification for its extreme level of independence from ordinary checks and balances.
[37] *See* Breyer, *supra* note 24, at 10–19; Christopher C. DeMuth and Douglas H. Ginsburg, "White House Review of Agency Rulemaking," 99 *Harvard Law Review*, 1075, 1081 (1986).

years ago, Anthony Downs claimed that bureaucrats' "views are based upon a 'biased' or exaggerated view of the importance of their own positions 'in the cosmic scheme of things.'"[38] Because of minimal inter-agency coordination, independent agencies produce an "uncoordinated stream" of regulation, with each agency pursuing its respective goal through the lens of its tunnel vision.[39] For example, increased environmental protection might conflict with other important goals, such as economic growth or national security.[40] Organizations also attract individuals that self-select for high interest in and commitment to the agency's regulatory function (rather than skepticism), thus producing a natural tendency to place excessive importance on the agency's particular task relative to other policy objectives.[41] This tendency is likely to be especially pronounced with respect to a new agency such as the CFPB, which was created in response to the financial crisis and was initially staffed by Democratic White House and congressional staffers who were "true believers" in the agency's mission and were hired by the agency's first leader, Elizabeth Warren. A massive influx of "true believers" into a regulatory agency can dramatically alter the trajectory of the agency with respect to regulatory policy, amplifying the policy initiatives of like-minded leaders and dampening efforts at course correction by future leaders.[42]

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[38] Anthony Downs, *Inside Bureaucracy*, 107 (1967).
[39] Angel Manuel Moreno, "Presidential Coordination of the Independent Regulatory Process," 8 *Administrative Law Journal of the American University*, 461, 464 (1994).
[40] See Todd J. Zywicki, "Baptists? The Political Economy of Environmental Interest Groups," 53 *Case Western Reserve Law Review*, 315, 327–33 (2002) (discussing an unwillingness of environmentalists to consider tradeoffs between environmental goals and other important goals).
[41] David B. Spence and Frank Cross, "A Public Choice Case for the Administrative State," 89 *Georgetown Law Journal*, 97, 120 (2000). "That agencies are systematically more loyal to their basic mission seems persuasive, even obvious. People who are sympathetic to that mission are more likely to be attracted to work at the agency."
[42] See Timothy J. Muris, "Regulatory Policymaking at the Federal Trade Commission: The Extent of Congressional Control," 94 *Journal of Political Economy*, 884, 888–90 (1986) (noting the influence on the Federal Trade Commission of a wave of Naderite consumer protection activists into the FTC in the 1970s and their contribution to the activist policies of the FTC in the 1970s).

This tunnel-vision focus is heightened when an agency is expressly tasked with a single-mission focus (such as the CFPB) rather than a multi-function mission, such as the FTC. The FTC, for example, balances the twin aims of consumer protection and increased competition both of which benefit consumers in different ways[43] This internal tension in pursuit of the end goal or maximizing overall consumer welfare facilitates the reinforcement and counterbalance of each goal against the other.[44] Unlike the FTC, however, the CFPB lacks both counterbalancing regulatory purpose, as well as a multi-member structure to facilitate collegial decision making. Thus, the existence of a single focus, consumer protection,[45] and single-director design creates a breeding ground for tunnel vision, favoring one aspect of consumer protection to the detriment other consumer benefits.

This tunnel-vision tendency may be exacerbated by the tendency observed by William Niskanen for agencies to be expansionist and imperialistic, not for reasons of mission but simple self-interest of their leaders in expanding the power, influence, and budgets of the agencies.[46] Not only will this expansionism be consistent with advancing the bureaucrat's personal interest in increasing power and wealth, but an aggressive and expansionist agency will also tend to increase the bureaucrat's value to the private sector if he or she decides to go through the "revolving door" from government into the private

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[43] Federal Trade Commission, *About the Federal Trade Commission*, http://www.ftc.gov/ftc/about.shtm (last visited April 12, 2012).

[44] Todd J. Zywicki, Testimony before the House Committee on Oversight and Government Relations, Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, "Who's Watching the Watchmen?" (May 24, 2011).

[45] Consumer Financial Protection Bureau, *Learn about the Bureau*, http://www.consumerfinance.gov/the-bureau/ (last visited July 15, 2012) (explaining that the "central mission of the Consumer Financial Protection Bureau (CFPB) is to make markets for consumer financial products and services work for Americans").

[46] See Niskanen, *supra* note 26; see also Todd J. Zywicki, "Institutional Review Boards as Academic Bureaucracies: An Economic and Experiential Analysis," 101 *Northwestern University Law Review*, 861 (2007) (discussing Niskanen's argument).

sector. For example, attorneys who participate in regulatory drafting will be in high demand to subsequently advise private clients on compliance, as will those who increase the enforcement activities of the agency.[47] Again, this tendency toward aggressive agency expansionism seems likely to be reinforced where, as is the case with the CFPB start-up, its leaders are using the organization as a launching pad for a political career or otherwise to promote themselves and their personal agenda, as was evidently the case with Elizabeth Warren.[48] Although such use of agency positions as a launching pad for personal ambition is rare, in such cases bureau heads can be predicted to use the agency as a vehicle for promoting their own partisan and personal ambitions by aggressively expanding its activities so as to garner publicity and news headlines. Finally, tendencies toward agency pathology are exacerbated by the fact that Dodd-Frank does not set forth any specifications or restrictions as to who may serve as director. Although most statutes refrain from requiring specific qualifications for appointees, doing so would create greater independence because "the pool of potential candidates from which the President picks is more limited and he or she cannot select solely on the basis of partisan leanings."[49]

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[47] See Paul J. Quirk, *Industry Influence in Federal Regulatory Agencies*, 143–74 (1981); see also Robert A. Katzmann, "Federal Trade Commission," in *The Politics of Regulation*, 152 (James Q. Wilson ed., 1980); Suzanne Weaver, "Antitrust Division of the Department of Justice," in *The Politics of Regulation, supra*, at 123.

[48] Consider, for example, the extraordinary interview with Elizabeth Warren for *Vanity Fair* magazine, a seemingly unique event for a Washington bureaucrat. See Suzanna Andrews, "The Woman Who Knew Too Much," *Vanity Fair* (November 2011), available at http://www.vanityfair.com/politics/features/2011/11/elizabeth-warren-201111.

[49] Rachel E. Barkow, "Insulating Agencies: Avoiding Capture through Institutional Design," 89 *Texas Law Review*, 15, 47 (2010). For example, at least two members of the three-member Surface Transportation Board must have a professional background in transportation, two of the five members of the PCAOB must be certified public accountants, and members of the Defense Nuclear Facilities Safety Board must be "respected experts in the field of nuclear safety." *Id*. Statutes can also impose restrictions. *Id*. For example, the Consumer Product Safety Act (CPSA) states a person cannot hold the office of Commissioner s/he is "in the employ of, or holding any official relation to, any person engaged in selling or manufacturing

A related bureaucratic bias is toward risk-averse decision making. Although efficient regulatory policy would require bureaucracies to weigh offsetting risks symmetrically, in fact bureaucratic decision-makers do not personally experience them symmetrically.[50] For example, when deciding whether to approve a new drug, the FDA should weigh equally the expected number of people who might be injured by premature approval of the drug by the number of people who might be injured by unnecessary delay in approval of the drug. In fact, however, leaders of the FDA (as with other bureaucratic agencies) tend to effectively weigh Type II errors (premature approval) more heavily than Type I errors (unnecessary delay) because the former is easier to observe and thus easier to criticize than the diffuse and seemingly more speculative second kind of cost. As a result, FDA leaders systematically weigh Type II errors more heavily than Type I, resulting in inefficiently risk-averse decision making.[51]

In the context of the CFPB's operations, this bias can be expected to take the form of undue focus on its consumer protection mission narrowly defined and to discount the benefits to consumers of lower prices, greater choice and innovation, and more robust competition.[52] Consumers certainly benefit from heightened consumer protection in financial services, including regulations that would impose enforced standardization and simplification on the products that consumers can purchase. For example, consumer protection issues certainly would be simplified if every mortgage and credit card and every agreement were required to have only one term (say the interest rate) and to be

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consumer products" or owns "stock or bonds of substantial value in a person so engaged" or "is in any other manner pecuniarily interested in such a person." *Id*. at 48.

[50] In technical terms. this would require so-called Type I and Type II errors to be treated symmetrically. For a discussion, see Stearns and Zywicki, *supra* note 23, at 358–61.

[51] See Henry I. Miller, *To America's Health: A Proposal to Reform the Food and Drug Administration* (2000).

[52] See Zywicki, "Who's Watching the Watchmen?" *supra* note 44.

otherwise identical, just as every computer or cell phone manufacturer could be required to offer a uniform simple computer or cell phone. Regulators also could eliminate the risk of foreclosures by requiring home sales to be in cash, thereby eliminating mortgages. Thus, "perfect" consumer protection must be traded off at the margin with other goals, such as lower prices, greater choice, innovation, and competition. The optimal consumer protection policy will weigh all these goals. Yet the CFPB—deliberately tasked to pursue consumer protection over everything else—simply is not structured to process these tradeoffs in a rational manner. The end result likely will be harm to consumers.

Consider, for example, the tradeoffs involved in regulating mortgage brokers. It is possible that mortgage brokers contributed to the financial crisis by innovating mortgages that created strong incentives for moral hazard on the part of consumers (as with nothing-down mortgages) as well as potentially contributing to agency cost problems in the origination and securitization of mortgages. Critics of mortgage brokers have pounced on these flaws to argue for new strict regulation of mortgage brokers.

But mortgage brokers have two distinct incentives. First, mortgage brokers have an incentive to maximize the "spread" between the rate at which they can acquire funds to lend to consumers (essentially the wholesale rate) and the rate at which they can lend to borrowers (the retail price). But second, mortgage brokers face competition from other brokers who are trying to get a borrower to borrow from them. The net result of these two factors—one pushing toward higher rates and one pushing toward lower rates—is ambiguous as an *a priori* matter.

Empirical studies have found various different results, some finding that brokers offer better terms on average than depository lenders and others finding that brokers charge higher prices on at least some elements of the transaction.[53] The explanation for these differing results appears to stem from differences in the number of mortgage brokers competing in a given market.[54] Where mortgage brokers are numerous and thus competition and consumer choice is greater, consumers generally receive lower interest rates from brokers (the competition effect predominates); but where there are a smaller number of brokers and less competition, consumers typically pay higher interest rates (the broker interest effect predominates). Empirical studies indicate that overly restrictive broker regulations may also lead to a higher number of foreclosures overall.[55]

As this simple example shows, when confronted with the potential contribution of mortgage brokers to the financial crisis, a well-intentioned consumer protection regulator could respond by imposing overly strict licensing regulations on mortgage brokers designed to protect consumers.[56] But onerous restrictions would reduce competition, resulting in higher prices and worse service and—perversely—leading to a higher number of foreclosures overall. While a well-balanced regulatory policy would thus take all these factors into account, the tunnel-vision focus of the CFPB focused on "consumer

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[53] Compare Amany El Anshasy, Gregory Elliehausen and Yoshiaki Shimazaki, "The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders" (working paper, July 2005), available at http://www.chicagofed.org/digital_assets/others/events/2005/promises_and_pitfalls/paper_pricing.pdf (finding that broker-originated mortgages are less costly to the borrower than lender-originated mortgages after holding other loan terms and borrower characteristics constant) and Gregory Elliehausen and Min Hwang, "The Pricing of Subprime Mortgages at Mortgage Brokers and Lenders" (46th Annual AREUEA Conference Paper, November 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1717013 (updated results confirming the initial findings) with Susan E. Woodward, "U.S. Dep't of Hous. and Urban Dev., A Study of Closing Costs for FHA Mortgages" (2008), available at http://www.huduser.org/Publications/pdf/FHA_closing_cost.pdf, at ix (concluding that loans made by mortgage brokers have higher costs of $300 to $425).

[54] See M. Cary Collins and Keith D. Harvey, "Mortgage Brokers and Mortgage Rate Spreads: Their Pricing Influence Depends on Neighborhood Type," 19 *Journal of Housing Research*, no. 2, at 153–70 (2010).

[55] See, e.g., Morris M. Kleiner and Richard M. Todd, "Mortgage Broker Regulations That Matter: Analyzing Earnings, Employment, and Outcomes for Consumers," in *Studies of Labor Market Intermediation* 183–231 (2009), available at http://www.nber.org/papers/w13684.

[56] It should be emphasized that I am aware of no evidence to indicate that strict licensing of mortgage brokers actually increases the overall average quality of mortgage brokers or their services for consumers.

protection" narrowly defined, combined with an inherent tendency toward risk-averse decision making runs the risk of leading to overzealous regulation while overlooking the benefits of competition and lower prices for consumers. This is precisely the sort of Type-I vs. Type-II error tradeoff that tends to be problematic for single-issue entities.

Similar tradeoffs can be easily identified for a whole range of issues that the CFPB might have to consider, from unconventional mortgage products to particular credit cards terms. For example, although upward increases in the interest rates on adjustable-rate mortgages were the major catalyst for the foreclosure crisis,[57] consumers unquestionably also benefit when interest rates fall. Moreover, fixed-rate mortgages pose extreme risks for consumers and the economy at large because of the interest rate mismatch problem that they potentially create (banks must raise lending capital in short-term borrowing markets in order to lend on long-term fixed-rate mortgages or securitize mortgages to pass along the risk) as well as interfering with the ability of consumers to refinance into lower interest rates when rates fall if they do not have equity in their homes.[58] As a result of the unique primacy of the thirty-year fixed-rate mortgage in the United States (no other country in the world has standardized on this product), for example, the housing bust has hit U.S. homeowners much worse than elsewhere, as millions of homeowners have been unable to refinance into record-low mortgage interest rates because they are underwater (not to mention needing to be sufficiently liquid to come up with several thousand dollars in closing costs).[59] If homeowners had adjustable-

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[57] See Gabriel Okolski and Todd J. Zywicki, "The Housing Market Crash," (Mercatus Center, working paper no. 09–35, September 2009), available at http://mercatus.org/sites/default/files/publication/WP0935_Housing_Market_Crash.pdf.
[58] See Todd J. Zywicki, "The Law and Economics of Fixed-Rate Mortgages (and Other Just-So Stories)," 21 *Supreme Court Economic Review* (forthcoming 2013).
[59] *Id.*

rate mortgages instead, as in most other countries, their interest rates and monthly payments would have ratcheted downward immediately, reducing payments for many, staving off foreclosure for some, and spurring macroeconomic recovery for all. Despite the obvious symmetry in risks on adjustable-rate mortgages to consumers, however, there is a risk that the CFPB might tend to focus on the risks entailed to consumers from upward movements in mortgage interest rates while discounting the benefits to consumers and the economy from downward adjustments, thereby creating rules that inefficiently favor the thirty-year fixed-rate mortgage.[60] This would effectively force millions of homeowners to pay thousands of dollars over the life of their loan for long-term insurance against increasing interest rates 25 or 30 years in the future.

Another bureaucratic bias is short-term bias in decision making. Rational political actors (including agency heads) will tend to favor policies that produce short-term gains but for which the costs are borne in the long run. Short-term gains permit the political actor to take credit for the policy while subsequent officials are forced to bear the costs, both economic and political. This will be the case especially with respect to an entity such as the CFPB, which has been headed since its inception by individuals with clear partisan political ambitions (such as Warren and Cordray) and thus can be expected to maximize short-term regulatory activity—such as high-profile lawsuits and regulations—while discounting the future costs of those activities, such as increased cost and reduced availability of credit. The ambiguous legality of Cordray's appointment adds further short-term bias; he wrote to his staff that, because his appointment may be illegal, "[t]his time period should give to each one of us, and not only me, a fierce urgency to

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[60] Any such additional subsidy already would be on the back of existing subsidies for the traditional mortgage, such as the implicit subsidy created by Fannie Mae and Freddie Mac's historic support for the product.

accomplish the work we are doing together."[61] The political process tends to be prone to short-term bias because the costs of bad regulation generally fall most heavily on lower-income and lower-educated individuals who are less likely to perceive the true source of their lack of credit access and less likely to be politically active. Thus, economists have found that historically the unintended consequences of heavy-handed governmental regulation of consumer credit have invariably fallen most harshly on low-income consumers, often with a regressive redistributive effect in favor of richer and middle-class consumers.[62]

A final potential problem created by the CFPB's combination of a single-industry mission combined with a lack of accountability is a risk of agency capture.[63] Historically, the problem of agency capture has arisen from the tendency of regulatory agencies to be "captured" by members of the industry that they were established to regulate, such as the Civil Aeronautics Board (captured by the airline industry[64]), the Interstate Commerce Commission (captured by the railroad and trucking industries[65]), or the Securities Exchange Commission (captured by the securities industry[66]). With respect to the CFPB, the threat of capture seems less likely to come from the industry as a whole than from particular segments within it—namely, the biggest banks. The CFPB promises an

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[61] "Consumer Protection Financial Bureau Director Richard Cordray Doubted Constitutionality of His Own Appointment, Documents Uncovered by Judicial Watch Show," *Market Watch* (April 19, 2012, 9:48 AM), http://www.marketwatch.com/story/consumer-protection-financial-bureau-director-richard-cordray-doubted-constitutionality-of-his-own-appointment-documents-uncovered-by-judicial-watch-show-2012-04-19.

[62] See Durkin, Elliehausen, Staten, and Zywicki, *supra* note 16, at Chapter 11 (surveying political economy and redistributional effects of consumer credit regulation through history).

[63] See Stearns and Zywicki, *supra* note 23, at 376–78 (describing problem of agency capture).

[64] Thomas K. McGraw, *Prophets of Regulation*, 263 (1984).

[65] Thomas Frank, "Obama and 'Regulatory Capture'," *Wall Street Journal* (June 24, 2009), available at http://online.wsj.com/article/SB124580461065744913.html.

[66] Jonathan R. Macey, "Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty," 15 *Cardozo Law Review*, 909, 922 (1994).

unprecedented onslaught of regulatory compliance costs that are likely to proportionally fall much harder on smaller and community banks than on the largest banks. It is well-established that certain types of regulatory compliance costs, such as many paperwork and other oversight costs, are largely invariant to the size or output of a firm, and thus fall proportionately harder on smaller firms in an industry.[67] It is unsurprising, therefore, that community banks and credit unions have expressed grave concerns about the punishing regulatory compliance costs imposed by Dodd-Frank and the CFPB.[68] In addition, smaller banks compete by providing more personalized service such as designing products specifically tailored to individual needs. Dodd-Frank and the CFPB, however, push toward making consumer credit more like a standardized commodity rather than permitting tailoring to the needs of particular borrowers.[69] As noted above, a similar issue arises with respect to mortgage brokers, which can provide an important competitive check on depository institutions.

This one-size-fits-all regulatory approach tends to thus disadvantage those banks that compete on margins such as customer service while favoring those with the lowest

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[67] B. Peter Pashigian, "A Theory of Prevention and Legal Defense with an Application to the Legal Costs of Companies," 25 *Journal of Law and Economics*, 247 (1982).

[68] See, e.g., Letter from Stephen P. Wilson, Chairman, American Bankers Ass'n, to Hon. Sheila Bair, Chairman, FDIC (March 21, 2010), available at http://www.aba.com/aba/documents/blogs/DoddFrank/ChairmanBairMar212011.pdf (identifying Dodd-Frank regulations which could negatively affect community banks); *Rising Regulatory Compliance Costs and Their Impact on the Health of Small Financial Institutions: Hearing before the Subcomm. on Financial Institutions and Consumer Credit*, 112 Cong. (2012) (statement of Ed Templeton on behalf of the Nat'l Ass'n of Fed. Credit Unions), available at http://financialservices.house.gov/UploadedFiles/HHRG-112-BA15-WState-ETempleton-20120509.pdf#page=4. "[A]dditional regulatory requirements mandated in this massive overhaul have added to the overwhelming number of compliance burdens for credit unions. Undoubtedly, an immense amount of time, effort, and resources will be expended at credit unions as they struggle to keep up with new regulation."

[69] The original idea proposed by the Obama administration of creating a preferred set of "plain vanilla" loan products is an example of a tendency toward commoditization of consumer lending products (although it was later rejected). See U.S. Dep't of Treasury, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation" 16 (2009), available at http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf. "We propose that the [CFPB] be authorized to define standards for 'plain vanilla' products that are simpler and have straightforward pricing."

costs, big banks that offer economies of scale and lower capital market costs (as a result, in part, of the entrenchment of the too-big-to-fail subsidy in Dodd-Frank). Finally, the big banks will have a comparative advantage in being able to make the expenditures to hire lobbyists and other Washington resources in order to influence CFPB decision making more readily than smaller banks. As a result, the regulatory compliance costs of the CFPB may have the unintended consequence of promoting capture of the CFPB by the large banks and promoting consolidation of the U.S. banking industry. For example, as a response to the financial crisis itself and Dodd-Frank's enactment, industry consolidation has reached an all-time high, as the five largest banks today hold over 39 percent of all deposits, up from 29 percent in 2005.[70] The combination of heavily regulatory costs and the entrenchment of the too-big-to-fail funding subsidy is likely to further accelerate this consolidation, thereby ironically increasing the importance of supposedly systemically risky institutions.

B. Institutional Devices for Restraining Bureaucratic Tendencies

Although all the aforementioned pathologies are endemic to bureaucratic decision making, scholars of regulation have also identified a number of countervailing forces that can mitigate the problems caused by these characteristics of bureaucratic decision making. These include congressional oversight, heightened executive control, and deliberative decision making by a multi-member commission. Yet each of these factors is largely absent in the case of the CFPB.

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[70] Independent Community Bankers of America, "Credit Rating Downgrade Highlights Danger of Banking Concentration: Deposit Concentration Is at an All-Time High," press release, (June 25, 2012), http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=128191.

It should be stressed at the outset that, in noting that these systemic checks can improve bureaucratic decision making, the point is not to suggest that they are somehow inherently superior to bureaucracies. In fact, many of these institutions may be subject to their own peculiar faults—such as congressional oversight motivated by political ends rather than the improvement of policy outcomes. The point instead is to note that the value may arise from a *combination* of these checks-and-balances in the regulatory process, just as the justification for the checks and balances imposed by the U.S. Constitution is that the outcome of the *system* of the interaction of the branches is thought to be superior than if all decisions were concentrated in one branch governed by the same internal dynamics arising from selection and internal operating procedures. Thus, for example, simply because it is the case that if forced to choose one or the other it might be preferred that we elected our officers, it does not follow that we are better off if *all* members of the government are elected (including, for example, judges). It is thought instead that we are better with a system of internal checks and balances, with the various branches comprised of individuals selected by different constituencies for different term lengths. Theories of regulatory control rest on the same basic idea—simply because we think that it is wise to vest primary decision-making authority in bureaucrats insulated from direct electoral or financial incentives does *not* imply that they should not be subject to supervision by any outside force.

Even informal mechanisms of control are absent from the CFPB to a striking extent. For example, Justice Breyer's dissenting opinion in *Free Enterprise Fund v. Public Company Accounting Oversight Board*,[71] noted that the formal removal power of

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[71] *Free Enterprise Fund* v. *Public Company Accounting Oversight Bd*., 561 U.S. ——, ——, 130 S.Ct. 3138, 3159, 177 L.Ed.2d 706 (2010).

members of the PCAOB was not a necessary condition for adequate control over an agency. He listed a number of other mechanisms of control over the independent PCAOB that sufficed in his view to make the body constitutional, such as how no accounting board rule takes effect unless and until the Securities Exchange Commission (SEC) approves it and the ability of the SEC to "abrogate[e], delet[e] or ad[d] to" any rule or any portion of a rule promulgated by the PCAOB. In addition, the SEC had the power to review and modify any sanction imposed by the Board, initiate any investigations, remove PCAOB members, or relieve the PCAOB of any of its responsibilities any time it believed that doing so would be in "the public interest."[72] As a result, Breyer argues, the SEC had effective power to be able to stop investigations and the like.

Virtually all these controls are absent in the case of the CFPB, however.[73] The Federal Reserve has no oversight at all over the CFPB's operations. And FSOC has no formal power to approve a rule or action—any rule issued by the CFPB automatically becomes effective unless vetoed by FSOC, which can be done only by supermajority vote and only if the rule or action would imperil the safety and soundness of the entire financial system. Thus, not only are the more obvious formal controls (removal by the president and appropriations by Congress) absent, even many of the informal controls typically seen in other agencies are absent as well.

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[72] *Id.* at 15–15 (Breyer, J., dissenting).
[73] Special thanks to Jay Wright for making this point to me.

1. Congressional Oversight

The CFPB is insulated from the most effective means of congressional oversight: annual budgetary appropriations.[74] Through the power of the purse, Congress can review agency regulatory and enforcement priorities as well as provide "teeth" backing up other types of oversight, such as public hearings. Active and effective congressional oversight can also help to guard against agency capture by interest groups by opening the claustrophobic and technical process of agency decision making to a broader array of information and constituencies. But Dodd-Frank completely insulates the CFPB from Congress's most potent oversight tool—appropriations authority—by instead guaranteeing its budgetary appropriations from the Federal Reserve without needing to justify itself to Congress.

The statute does give the Senate power to confirm the director of the agency, which in theory gives Congress some modicum of control over the agency. But even this modest degree of congressional oversight was thrown out the window when the Obama administration named Richard Cordray to be acting director of the agency via a claimed recess appointment. Whether Cordray's appointment was a valid recess appointment is open to question and has been subject to legal challenge.[75] Even if Cordray's appointment was valid as a constitutional matter, however, there is still the additional statutory question of whether an acting director that has not been confirmed according to

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[74] Congressional oversight has been recognized as potentially powerful means of restraining bureaucratic agency costs. See Barry R. Weingast and Mark J. Moran, "Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission," 91 *Journal of Political Economy*, 765, 767–69 (1983).

[75] C. Boyden Gray and Jim R. Purcell, "Why Dodd-Frank is Unconstitutional," op-ed, *Wall Street Journal* (June 21, 2012), http://online.wsj.com/article/SB10001424052702304765304577480451892603234.html. "[W]e filed a lawsuit on Thursday asking a federal court to declare that two parts of Dodd-Frank violate a bedrock rule of law: the Constitution's separation of powers, which the Founders designed specifically to limit the growth of government."

the advice and consent of the Senate can validly exercise the full scope of authority of the CFPB, including the power to regulate actors not traditionally regulated by the federal government, such as non-bank lenders and debt-collection agencies. The statute provides that authority to regulate these parties shifts to the CFPB only open the naming of a "confirmed Director" defined by the statute as one requiring the "advice and consent" of the Senate.[76] This suggests that the vesting of the full scope of the powers of the CFPB can come about only on the actual confirmation of a director, not merely by naming an acting director.

In addition, this highly politicized end-run around the Senate's advice-and-consent power to confirm the CFPB director comes on the heels of the Obama administration's earlier decision not to nominate a director for the entire first year of the agency's existence but instead to charge Elizabeth Warren with the task of setting up and staffing the agency from within the White House as assistant to the president and special advisor to the secretary of the Treasury on the CFBP.[77] This decision immediately belied the stated justification for the extreme level of independence provided to the CFPB, namely, that it would be a non-political expertise-based agency. Finally, it appears that there has been an unusually close coordination between the CFPB and the White House to boost President Obama's agenda and re-election efforts.[78] More importantly, by end-

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[76] See Todd Zywicki, "Legality of Cordray Appointment under Dodd-Frank," *Volokh Conspiracy* (January 4, 2012, 5:04 PM), http://www.volokh.com/2012/01/04/legality-of-cordray-appointment-under-dodd-frank/.

[77] White House Office of the Press Secretary, "President Obama Names Elizabeth Warren Assistant to the President and Special Advisor to the Secretary of the Treasury on the Consumer Financial Protection Bureau," press release, (Sep. 17, 2010), available at http://www.whitehouse.gov/the-press-office/2010/09/17/president-obama-names-elizabeth-warren-assistant-president-and-special-a.

[78] See Letter from Patrick McHenry, Chairman, Subcomm. on TARP, Financial services, and Bailouts of Public and Private Programs, to Richard Cordray, Director, CFPB (July 2, 2012) (detailing interactions between CFPB leadership and White House); see also Mary Kissell, "Consumer Financial Political

running the confirmation process, the White House defeated even the very slight mechanisms of accountability built into the statute to preserve a congressional hand in overseeing the agency's operations, leaving virtually no congressional control at all.

2. Executive Branch Oversight

Checks to encourage the rationality of agency decision making can also be imposed from the Executive Branch through a variety of mechanisms. But these typical protections are absent in the case of the CFPB as well.

First, the president lacks the authority to remove the bureau director except for cause, defined to exclude policy disagreements with the president. The ability of the president to remove his appointees is the *sine qua non* of the ability of the executive to control the execution of the law.[79] Moreover, the president and executive branch have no control or authority to instruct the CFPB to take any position including congressional testimony or the like.[80] Thus, the only effective control held by the president is the initial nomination of the director and a removal authority only under the strictest standards of malfeasance.

Bureau," *Wall St. Journal* (July 5, 2012), http://online.wsj.com/article/SB10001424052702304299704577503332343808706.html.

[79] See Neomi Rao, "The Removal Power: Constitutionally Necessary, Constitutionally Sufficient" 1 (Center for Business Law and Regulation at Case Western Reserve University School of Law, working paper, April 5–6, 2012) "[T]he ability to remove administrative agency heads is both necessary and sufficient to ensure presidential control."

[80] 12 USCA § 5492(c)(4) (West 2012). "No officer or agency of the United States shall have any authority to require the Director or any other officer of the Bureau to submit legislative recommendations, or testimony or comments on legislation, to any officer or agency of the United States for approval, comments, or review prior to the submission of such recommendations, testimony, or comments to the Congress, if such recommendations, testimony, or comments to the Congress include a statement indicating that the views expressed therein are those of the Director or such officer, and do not necessarily reflect the views of the Board of Governors or the President."

Second, the president lacks the authority to coordinate the policies of the CFPB with other governmental agencies. Because of the tendency of agencies to expand their power and their tunnel-vision focus on their mission at the exclusion of other policy ends, there is a need for the executive branch to create coordination and coherence among different agencies pursuing different objectives. Although a variety of measures have been used through history to bring this about, in recent decades presidents of both parties have come to rely on the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) to perform this task.[81] Cass Sunstein and Richard Pildes have summarized the beneficial role of OIRA to "diminish some of the characteristic pathologies of modern regulation—myopia, interest group pressure, draconian responses to sensationalist anecdotes, poor priority setting, and simple confusion."[82] Yet by tradition independent agencies are excluded from OIRA's reach, and that practice has extended to the Federal Reserve, and by implication, the CFPB as well.[83]

Leaving aside the legal formalities, as a matter of sound policy, this exclusion of the CFPB from OIRA's reach is difficult to justify.[84] It is not clear why independent

[81] See Strearns and Zywicki, *supra* note 23, at 366–67 (discussing role of OIRA in coordinating agency policy); *see also* Nicholas Bagley and Richard L. Revesz, "Centralized Oversight of the Regulatory State," 106 *Columbia Law Review*, 1260, 1264 (2006).
[82] Richard J. Pildes and Cass R. Sunstein, "Reinventing the Regulatory State," 62 *University of Chicago Law Review*, 1, 4 (1995).
[83] See Barkow, *supra* note 49, at 31–32 (noting that presidents by executive order have exempted independent agencies that are defined in the Paperwork Reduction Act from having to submit a cost-benefit analysis of their rules to OIRA). This exclusion may be implied by the statutory language of Dodd-Frank as well. See 12 U.S.C. § 5497(a)(4)(E) (West 2012) (statute "may not be construed as implying any obligation on the part of the Director to consult with or obtain the consent or approval of the Director of the Office of Management and Budget with respect to any report, plan, forecast, or other information…or any jurisdiction or oversight over the affairs or operations of the Bureau").
[84] See John Morrall, Richard Williams, and Todd Zywicki, "The Next Hot Ticket in Financial Reform," *Reuters* (October 8, 2010), http://blogs.reuters.com/great-debate/2010/10/08/the-next-hot-ticket-in-financial-reform/; see also Risa Gordon, "Rulemakings at the Fed, CFPB Need White House Supervision," *RegBlog* (July 18, 2011) http://www.law.upenn.edu/blogs/regblog/2011/07/rulemakings-at-the-fed-cfpb-need-white-house-supervision.html (explaining that subjecting CFPB to OIRA review "would likely yield a number of benefits, including increased public trust through greater government transparency, enhanced

agencies have been exempted from OIRA's reach, but one possible justification is that independent agencies have alternative mechanisms of control that executive branch departments do not. For example, independent agencies typically are headed by a multi-member commission, often bipartisan in composition, and the deliberative process generated by this commission structure may provide a partial substitute for OIRA review. Given the absence of any similar internal checks on the CFPB's activities, its single-director structure and single-mission focus suggests the soundness of OIRA review of its actions.[85] Yet the CFPB remains outside the control of both OIRA and the Fed.

3. Absence of Judicial Control

Judicial supervision of the CFPB also is attenuated. In particular, the Dodd-Frank legislation expresses Congress's intention that the CFPB's actions shall be inherently subject to *Chevron* deference by the judiciary.[86] This mandated degree of deference reduces the scope for judicial review of the CFPB's actions, thereby still further reducing oversight of the CFPB's operations. In addition, Dodd-Frank provides that, regarding matters within its scope, the CFPB's interpretation shall prevail over that of rival agencies with respect to conflicts (such as with prudential regulators).

4. Absence of Multi-Member Structure

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alignment with democratic ideals, reduced risk that regulated firms will capture the agencies, and better inter-agency coordination").

[85] *Id.*

[86] 12 USCA § 5512(b)(4)(B) (West 2012). "[T]he deference that a court affords to the Bureau with respect to a determination by the Bureau regarding the meaning or interpretation of any provision of a Federal consumer financial law shall be applied as if the Bureau were the only agency authorized to apply, enforce, interpret, or administer the provisions of such Federal consumer financial law."

As noted, the CFPB is unusual in that it is *both* an independent agency and a single-director leadership structure instead of a multi-member commission. In addition, unlike other agencies such as the FTC, the CFPB also lacks internal checks and balances that can encourage efficient regulation.

The institutional structure of the CFPB can be usefully contrasted with that of the FTC. Founded in 1914, the FTC has survived for almost a century and has proved flexible and adaptable enough to regenerate itself over time.[87] Most significant, until the formation of the CFPB, the FTC was the primary federal consumer protection agency. To be sure, the FTC's jurisdiction with respect to consumer financial services was limited by its inability to reach banks. But still, the FTC exercises control over debt collectors, mortgage brokers, and credit reporting agencies. In addition, the FTC exercises authority over a range of consumer protection issues, such as false advertising claims and the like.

Because of this durability, the FTC provides a useful contrast to the CFPB. The FTC is subject to the appropriations power of Congress. This congressional oversight authority has proven useful in the past when necessary to rein-in the FTC when it went astray. In fact, the FTC's excesses became so pronounced in the 1970s and 1980s that at one point the agency lost its congressional authorization to operate and was on a year-to-year temporary authorization until fully reinstated just a few years ago. In addition, as noted above, the FTC is a multi-member bipartisan commission with a dual mission of consumer protection and competition, which knowledgeable FTC veterans recognize has provided a source of strength in creating effective policies. Indeed, few FTC veterans are likely to argue that consumers would be well-served by spinning off FTC's Bureau of

[87] Harris and Milkis, *supra* note 27.

Consumer Protection and giving it unconstrained regulatory powers—which is essentially what Dodd-Frank does with respect to the CFPB.

The CFPB, by contrast, is devoid of any of these external or internal balancing devices. Consider in particular the value of an independent agency having a multi-member bipartisan governance structure, a feature which academic literature often reviews as distinguishing characteristics of independent agencies, along with for-cause removal of agency heads and OIRA exemption.[88] The U.S. Supreme Court has described agency independence as a function of several different factors, one of which its of which is "composition as a multimember bipartisan board."[89] In fact, "[m]ost independent agencies have multimember boards, and the conventional wisdom is that boards increase insulation because typical features such as staggered terms and bipartisan requirements limit the impact of individual appointments."[90]

Support for single-director design has often had an ideological motivation as well. As was the case with the CFPB, advocacy groups with liberal policy-orientation have advocated for a single-director design under the presumption that the current director will enact a liberal-friendly agenda.[91] Moreover, the original design of the agency—a single director with a fixed term, insulated from presidential removal and congressional budgetary appropriations—may have been designed to enable the initial director (presumed to be Elizabeth Warren at the time the agency was being established)

[88] Barkow, *supra* note 49, at 31–32.
[89] Other factors include, *inter alia*, the use of the word "independent" in its authorizing statute, for-cause removal, and "a political environment, reflecting tradition and function, that would impose a heavy political cost upon any President who tried to remove a commissioner of the agency without cause." *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd*., 130 S. Ct. 3138, 3183 (2010).
[90] "Dodd-Frank Act Creates the Consumer Financial Protection Bureau – Dodd-Frank Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (to Be Codified in Scattered Sections of the U.S. Code)," 124 *Harvard Law Review*, 2123, 2128 (2011) [hereinafter "Dodd-Frank Creates CFPB"].
[91] "Oppose Attempts to Undermine the New Consumer Bureau," *Public Citizen* http://www.citizen.org/do-not-cut-consumer-protections (last visited May 1, 2012).

sufficient time and independence to hire initial staff (largely comprised of Democratic activists, Obama administration officials, and former Democratic congressional staffers) and entrench an initial liberal agenda and staff without interference from Republicans. By the time Dodd-Frank was enacted into law, it was already evident that Republicans were likely to take at least one house of Congress during the 2010 midterm elections and that a Republican could take the White House in the 2012 presidential election. Thus, the obvious goal of Democrats and liberal activists in investing the new agency with such a large degree of independence was to entrench the activist agenda of the new agency as deeply as possible to withstand predicted incoming hostile political winds.

Collegial decision making can also be a valuable grounding force when an agency is insulated from effective external oversight and input, such as the CFPB is. Collegial processes increase the quality and variety of information considered, and the aggregation of information through the deliberative process can improve accuracy and output quality. Multi-member decision making can also temper idiosyncratic or extreme outlying views that might otherwise be held by a single person. Collegial processes can also make use of and encourage specialization among commission members, thereby encouraging a division of labor and the improvement of overall decision making. In addition, collegial processes can discipline decision making by forcing proponents of particular actions to articulate a coherent rationale to support their decisions, thereby reducing the threat of biased, ill-considered, or politically motivated decisions.[92]

Perhaps the closest analogue to the radical degree of independence of the CFPB is that of appellate courts. Scholars who have studied appellate courts have found that comprising multi-member appellate panels of judges with different ideological and

[92] "Dodd-Frank Creates CFPB," 124 *Harvard Law Review*, 2123, 2128 (2011).

partisan leanings can improve decision-making processes. The collegial process itself can improve judicial rulings by enabling new information to be considered and forcing articulation of a principled rationale for decisions.[93] Collegiality can also dampen extreme views and increase consensus-style decisions.[94] In addition, scholars have argued that bipartisan panel composition of appellate panels can serve a "whistleblower" function that constrains partisan and ideological decision making.[95] As with federal judges, in the absence of external political constraints, internal deliberative processes can improve decision making and provide constraints against politically motivated or ill-informed decisions.

Collegial decision making on corporate boards provides another useful analogue to agency decision making.[96] The justification for corporate boards, rather than dictatorial

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[93] Harry T. Edwards, "The Effects of Collegiality on Judicial Decision Making," 151 *University of Pennsylvania Law Review*, 1639, 1645 (2003).

[94] See Cass R. Sunstein, David Schkade, Lisa M. Ellman and Andres Sawicki, *Are Judges Political? An Empirical Analysis of the Federal Judiciary* (2006).

[95] See Frank B. Cross and Emerson H. Tiller, "Judicial Partisanship and Obedience to Legal Doctrine: Whistleblowing on the Federal Courts of Appeals," 107 *Yale Law Journal*, 2155 (1998).

[96] See Daniel P. Forbes and Frances J. Milliken, "Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups," 24 *Academy of Management Review*, 489, 490 (1999); Stephen M. Bainbridge, "Why A Board? Group Decisionmaking in Corporate Governance," 55 *Vanderbilt Law Review*, 1, 12–19 (2002). Consider, e.g., the following example:

> Students with at least one undergraduate course in macroeconomics were presented with a computer-generated model requiring them to make economic policy decisions. Specifically, students were required to set interest rates so as to meet both inflation and unemployment targets…[I]ndividual and group play rounds alternated. Again, there was no statistically significant difference in the speed with which groups and individuals made decisions. Again, group scores were higher than individual scores. Notably, when subjects acted alone, the "ersatz monetary policymakers moved interest rates in the wrong direction" more often than did groups.
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> One significant finding is that the average performance of the five individuals making up the group had almost no explanatory power with respect to how well the group performed. Even more striking, the performance of the best member of the group did not predict group performance…[T]hese findings take on considerable importance in evaluating the merits of decisionmaking by interacting groups. In sum…"two heads—or, in this case, five—are indeed better than one."

Id. at 15–16.

CEOs, is that collective governance is more effective than vesting power in an individual. To be sure, individual control of a corporation would promote swifter and more decisive action. But collective corporate governance permits the board to collect, process, store, discuss, and retrieve information more thoroughly and accurately than one person acting alone. Also, collective governance can constrain over-confidence or cognitive errors by providing critical assessments and viewpoints of proposals. Collective governance can also constrain shirking, self-dealing, and capture by providing multilateral monitoring and raising the number of people who need to be corrupted for improper action to occur.

A bipartisan, multi-member commission also can temper extreme policy swings over time. Despite serving a five-year term, the CFPB's single director has a long-term effect due to the institutional and interpretive framework of regulatory law. Under the *Chevron* doctrine,[97] the federal judiciary defers to an agency's reasonable interpretation of ambiguous federal statutory language, which already tends to magnify policy swings among administrations.[98] This effect is further exacerbated, as the Dodd-Frank Act essentially codified *Chevron* for the purposes of CFPB interpretations, thereby excluding the potentially tempering effect of alternative formulations from other agencies or the judiciary.[99]

An interesting theoretical discussion can be had about the various pros and cons of a single-director design over multi-member agencies—when the director is

[97] See *Chevron U.S.A. Inc. v. Natural Res. Def. Def. Council, Inc.*, 467 U.S. 837 (1984).
[98] See Stearns and Zywicki, *supra* note 23, at 327–40.
[99] 12 USCA § 5512(b)(4)(B) (West 2012). The effect of policy swings may be longstanding, as agency actions have long-term implications due to the friction of the political process. Once an agency acts, interests groups are divided into winners and losers. Because interest groups can block rather than pass legislation with greater ease, winners block the passage of new legislation to undue agency actions, rendering Congress less able to restore equilibrium and undo an agency action it disfavors. Todd J. Zywicki, "Who's Watching the Watchmen?" *supra* note 44.

accountable to the president.[100] A single director lacks the information-gathering, continuity-promoting, and ideology-dampening benefits of collegial process but has benefits in terms of swiftness and accountability. But, be that as it may in the abstract, it obviously does not follow that a single-director agency largely unaccountable to the president, Congress, or even the multi-member Federal Reserve Board, would be seen as an improvement over a bipartisan commission structure. Indeed, the single-director structure devoid of accountability that the CFPB has chosen appears to be unique in recent American history.

C. The CFPB Does Nothing about the Real Causes of the Crisis or the Substantive Failures of Financial Consumer Protection Law—and Creates New Problems

Thus, the architects of the CFPB were correct in criticizing the hydra-headed consumer financial protection structure that was in place. The CFPB was also correct in criticizing the defects in the substantive rules governing consumer credit as well. But the CFPB does nothing to address the real cause of the crisis in the structure of consumer financial protection law or the underlying consumer-related issues that generated the financial crisis. By failing to understand the real problems that plague the consumer financial protection system, the CFPB will not actually provide real solutions (except by coincidence) and will actually create new problems.

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[100] See, e.g., *President's Advisory Council on Executive Organization, A New Regulatory Framework*,31(1971) (the “Ash Report”).

1. The Causes of Substantive Failures of Federal Financial Consumer Protection Law

The architects of the CFPB correctly recognized that the substantive rules were suboptimal. For example, the layers of confusing paperwork surrounding mortgage originations created a nearly impenetrable thicket that did little to dispel consumer confusion or protect consumers from fraud. Thus, the mandate in Dodd-Frank to create a single integrated simplified mortgage disclosure form was a productive instruction (although as noted below, the CFPB's actual proposal squanders this invitation).[101] Moreover, it is obvious that disclosures on a variety of consumer credit products, such as credit cards, could be made more transparent and consumer friendly.

But the architects of the CFPB were largely incorrect when they misdiagnosed the causes of the failures in substantive consumer protection policies. Moreover, in failing to address the underlying problems, the architects of the CFPB will create unintended consequences that will prove harmful to consumers in the long run—and likely contribute to the next financial crisis. Indeed, had certain provisions of Dodd-Frank been on the books during the most recent crisis, they would have worsened the problems that occurred.

But the CFPB's approach to these problems raises two perils. First, it raises the risk that by focusing on the problem of complexity in consumer credit products as an end in itself, the CFPB will enact regulations that will impose artificial simplification on products in a manner that is inefficient for consumers. Second, the CFPB's approach largely ignores the real causes of unhealthy complexity: namely, excessive regulation and

[101] See "Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z),"— Fed. Reg. — (July 9, 2012).

litigation. By misunderstanding the causes of those problems, the CFPB is likely instead to offer more of the same, further undermining the effectiveness of consumer financial protection rules.

a. A Simple-Minded Focus on Simplicity

Consider first the CFPB's simple-minded approach to the complexity of consumer credit products. Elizabeth Warren, for example, has argued that the only reason for increased complexity in credit card agreements is to create "tricks and traps" for consumers.[102] This is nonsense. Nearly everything that consumers purchase is too complex for them to understand all the details, features, and dangers of the products, whether cars, computers, or medical services. But it would be absurd to argue that the only reason why sellers have replaced typewriters with computers is *because* computers more complex and bewildering than typewriters, thereby enabling computer sellers to trick and harm consumers more easily. Similarly, although credit cards today are more complicated than credit cards forty years ago, it does not follow that the intent is to confuse consumers. Similarly, a modern Honda Civic is infinitely more complex than a Model-T, and while consumers might be able to understand and repair their Model-T, that is not possible for a Honda Civic. Yet the fact that a Model-T is simpler than a Civic does not mean that we should mandate a return to the Model-T or urge consumers to buy them. Thus, while simplification is a useful goal, it cannot be a transcendent goal in itself without a consideration of functionality and the role of consumer choice.

Consumer credit products are similar. Credit card agreements today are substantially more complex than credit card agreements forty years ago—the

[102] Warren, *supra* note 1.

metaphorical typewriters of the consumer credit age. But that is primarily because *credit cards* are more complex than credit cards four decades ago. In turn, the reason why credit cards are more complicated today than in the past is because consumers use credit cards in more complicated and elaborate ways than in the past. Forty years ago, credit cards were relatively simple products—but they were also exceedingly unattractive products for consumers: They carried a high annual fee ($40 or more), a high fixed interest rate (usually about 17 percent or more), and offered no ancillary benefits such as frequent flyer miles, car rental insurance, or the like.[103] Moreover, crude, inflexible, and simple pricing terms prevented card issuers from effectively pricing risk. As a result, many consumers who wanted credit cards could not obtain them and credit lines were lower because of the inability to price risk accurately. Those unable to obtain credit cards were forced to rely instead on personal finance companies, pawn shops, and other high-cost lenders.

Today, by contrast, credit cards have more price points—in large part because of the evolution of more efficient risk-based pricing on credit card terms and because of consumer demand for increased functionality, and hence complexity, of cards.[104] Risk-based pricing has enabled higher credit lines and the extension of credit cards to a more heterogeneous group of consumers but also requires more sophisticated and nuanced pricing for those more heterogeneous consumers. Consumer demands to use credit cards for a greater variety of purposes—such as a purchase or credit mechanism, for cash-back,

[103] See Zywicki, *supra* note 18.
[104] See Nadia Massoud, Anthony Saunders, and Barry Scholnick, "The Cost of Being Late: The Case of Credit Card Penalty Fees," (AFA Chicago Meetings, working paper, October 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890826; U.S. Gov't Accountability Office, GAO-06-929, "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers" (2006).

for small businesses or for travel around the world—has made it necessary for card issuers to create prices for all these various functions. Thus, credit card agreements are complicated primarily because credit cards themselves are complicated, and credit cards are complicated because consumers have demanded increasingly complicated functionality for credit cards. This has come about largely through a beneficial process of dynamic competition to meet evolving consumer demand, not as a vehicle for credit card issuers to lay "tricks and traps" for unwitting consumers.

The CFPB's misplaced obsession with simplicity over functionality is best exemplified by the initial proposal to create a preferred menu of "plain vanilla" credit offerings for consumers. The proposal ignores that the proper regulatory goal should not be to minimize complexity of consumer credit products as an end in itself any more than simplicity should be an end goal for cars, computers, or professional services. The goal should be to reach the *optimal* level of complexity so as to preserve functionality and risk-based pricing while enabling consumers to obtain the information that they need to make intelligent decisions and promote competition. For example, although credit cards are complex, a large majority of consumers report that they find it easy to obtain the information that they need about credit cards and that it is easy to switch to another card if they are dissatisfied or feel mistreated.[105] Indeed, an overwhelming majority of consumers express satisfaction with their credit cards and card issuers, exactly what would be predicted in a market as competitive and with such low switching costs as the credit card market. An undue focus on simplification, therefore, risks sacrificing functionality in order to fit the product's attributes into the straitjacket of the preferred

[105] See Thomas A. Durkin, "Credit Cards: Use and Consumer Attitudes, 1970–2000," 86 *Federal Reserve Bulletin* 623–634 (2000). Presumably since the growth of the Internet, information about credit card terms is even more accessible than previously.

disclosure format, rather than fitting disclosure regulation to the product's substantive attributes. This is especially so in light of the development of specialized websites such as Cardhub.com, which make it increasingly easy for consumers to identify the products that best meet their individual needs, much in the way private third-party rating institutions such as Consumer Reports provide critiques of other products and services. "Plain vanilla" products would be appropriate for "plain vanilla" borrowers, but few if any "plain vanilla" consumers exist.[106]

Moreover, one cannot simply assume that complex loan products are a vehicle for lenders to exploit hapless borrowers. Economists have found, for example, that during the financial crisis complex mortgage products (such as negative amortization loans) were disproportionately used by sophisticated, high-income borrowers with prime credit scores.[107] Although they found that complex mortgages did indeed have higher default rates than predicted, this was because they attracted sophisticated borrowers who are more strategic and rational in their default decisions, not because unsophisticated borrowers were unwittingly duped into them.[108] Other economists similarly have concluded that "predatory lending" was not a primary cause of the financial crisis.[109]

[106] For example, many so-called credit card consumers are not "consumers" at all but instead are consumers using personal credit cards to start or build a small business. See Thomas A. Durkin, "The Impact of the Consumer Financial Protection Agency on Small Business," (2009), available at http://www.uschamber.com/sites/default/files/reports/090923cfpastudy.pdf.
[107] See, e.g., Gene Amromin, Jennifer C. Huang, Clemens Sialm, and Edward Zhong, "Complex Mortgages," 31–32 (AFA Chicago Meetings, working paper 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1714605.
[108] *Id.*
[109] Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, and Douglas D. Evanoff, "Predatory Lending and the Subprime Crisis," 32–33 (Fisher College of Business, working paper no. 2012-03-008 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2055889.

b. The Real Causes of Complexity: Regulation and Litigation

A second reason for the complexity of consumer credit disclosures is the by-product of decades of litigation and regulation that have forced ever-greater burdens on credit issuers in order to comply with a thicket of federal regulation and to avoid liability for technical violations of statutes and regulation. When first enacted some forty years ago, the premise of the Truth in Lending Act (TILA) was simple: to create a standardized format for disclosures on consumer credit that would enable consumers to quickly engage in apples-to-apples comparisons among various different lending products to find the cheapest and more efficacious product for their needs.[110] When first proposed by Congress in the 1960s, TILA was simple and compact, designed simply to provide a standardized format for disclosing the interest rates (or APR) for consumer loans.[111] But between the enactment of the statute in 1968 and 2007, TILA was amended twenty-five times—including one major revision in 1980—and filled fifty-five double-column pages for the statutory language alone.[112]

In addition, the Federal Reserve Board has amended its Regulation Z, which implements TILA more than fifty times. Federal Reserve economists Thomas A. Durkin and Gregory Elliehausen describe the current state of Regulation Z:

> In the *Code of Federal Regulations* (CFR) for January 1, 2009, the regulation measured almost 300 double-column pages of small type including twelve appendices, a lengthy official interpretation of the regulation by the Federal Reserve Board staff known as the *Commentary* (updated at least yearly), and a four-page *Joint Policy Statement* concerning restitution in cases of inaccurately disclosed annual percentage rates. In all, Regulation Z contains well over 125,000 words of complicated legalese, enough to fill a sizable book. In 1976, the Federal

[110] Thomas A. Durkin and Gregory Elliehausen, *Truth in Lending: Theory, History, and a Way Forward*, 9–10 (2011).
[111] *Id.*
[112] *Id.*

> Reserve Board assigned a separate rule to consumer leasing, Regulation M, which by year end 2008 consisted of another fourteen pages in the CFR, plus its own *Commentary* of twelve more pages. The sheer mass of the Truth in Lending Act and its associated regulations, together with its technical nature and frequent changes, has generated an industry of lawyers, consultants, trade associations, and printing and software companies dedicated to aiding creditors in complying with TILA.[113]

Class action litigation piled still further complications onto TILA. According Durkin and Elliehausen, by 1979 more than 13,000 TILA lawsuits had been filed in federal courts—a full 2 percent of the entire federal civil caseload and up to 50 percent of the cases in some districts.[114] This stream of litigation in turn produced a stream "of unending and inconsistent… judicial decisions, interpretation, and reinterpretations, each of which could mandate costly new paperwork, procedures, and employee training."[115] In turn, this chaos spawned a cottage industry of Federal Reserve interpretations designed to clarify and bring coherence to these conflicting interpretations—by 1980, the Federal Reserve and its staff had published more than 1,500 interpretations of TILA with varying degrees of legal authority. Despite these good intentions, the Federal Reserve's interpretations simply spawned further litigation to interpret them and to establish their legal authority.

Much of this early chaos was mitigated by a substantial reform in 1980 that simplified TILA to some extent but spawned its own subsequent onslaught of regulation and litigation. For example, in 2008 the Federal Reserve Board undertook to amend Regulation Z solely for open-ended credit.[116] The new text of the rules added 159 pages of regulation and 266 pages of additional official Commentary (interpretations) by the

[113] *Id.*
[114] *Id.*
[115] Durkin and Elliehausen, *supra* note 110, at 9–10.
[116] *Id.* at 12.

Federal Reserve staff. There were also 16 new model forms and 611 pages of supplementary interpretations and elaborations on the foregoing. At the same time, the Federal Reserve Board approved almost 500 pages of amendments to other regulations that touched on credit card issues. Then, dissatisfied with the Federal Reserve's efforts, Congress passed still further amendments to TILA in 2009 that provided further direction to the Federal Reserve, necessitating still further regulatory revisions. In all, these regulations touched on and required changes to virtually every aspect of credit card operations.[117]

But the architects of the CFPB seem to be largely unaware of the fact that much of the dysfunction in the consumer protection system that they criticized resulted from excessive regulation and litigation. As such, rather than offering an antidote to the cause of complexity in financial disclosures, the CFPB instead suggests that the answer will be more of the same. For example, the CFPB estimates that the one final rule that has been issued as of the writing of this article—a rule governing cash remittances—will impose 7,684,000 hours of compliance time for providers of cash remittance services.[118]

According to a recent survey of in-house counsel at leading financial institutions, 78 percent of respondents expected that CFPB supervision, examination, and regulation will increase their company's regulatory costs by at least 20 percent.[119] As noted above, this massive increase in the regulatory and supervisory burden will be much easier for large banks to digest than smaller ones, which will be forced to dramatically increase

[117] A similar story could be told about the accumulation of legislation, regulation, and litigation involving home mortgages as well, which created the need for simplification with which CFPB is charged.
[118] See "Electronic Fund Transfers (Regulation E)," 77 *Federal Register* 6194, 6285 (February 7, 2012) (to be codified 12 C.F.R. part 1005).
[119] Jenna Greene, "In-House Lawyers Concerned about Future CFPB Enforcement Efforts, Survey Finds," *Legal Times* (July 12, 2012), http://legaltimes.typepad.com/blt/2012/07/in-house-lawyers-concerned-about-future-cfpb-enforcement-efforts-survey-finds.html.

their expenditures on legal fees and to divert employees from other activities to regulatory compliance efforts.[120]

Dodd-Frank also includes a number of special-interest provisions that will increase litigation and primarily benefit class action lawyers, a major constituency of President Obama and the Democratic Party. For example, Dodd-Frank bans mandatory arbitration provisions in mortgage and home equity loan contracts[121] and mandates that the CFPB conduct a more general study on the use of arbitration clauses in consumer credit contracts[122]. In light of the historically close ties between CFPB Acting Director Richard Cordray and the class action plaintiff's bar,[123] there is reason to believe that the CFPB may take a dim view of the value of arbitration clauses to consumers.

More generally, 98 percent of respondents to a recent poll of in-house counsel at financial institutions expect private litigation to increase as a result of the CFPB, with 32 percent expecting a large increase.[124] In addition, private parties have expressed grave concern about the power of the CFPB to share documents and information obtained during compliance oversight activities with state attorneys general.[125] Financial

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[120] See "On The Record: Community Bankers Speak Out on the Impact of Dodd-Frank Regulations," Committe on Financial Services. Blog of Spencer Bachus (October 17, 2011), http://financialservices.house.gov/Blog/?postid=264807.

[121] 15 USCA § 1639c (West 2012).

[122] 12 USCA § 5518 (West 2012).

[123] See, e.g., Michael I. Krauss, "Tort Lawyers' Dream, Economy's Scourge: Richard Cordray and the CFPB," *American Thinker* (October 18, 2011), http://www.americanthinker.com/2011/10/tort_lawyers_dream_economys_scourge_richard_cordray_and_the_cfpb.html; Daniel Fisher, "Nominee Cordray Had Solid Backing From Securities Lawyers," *Forbes* (July 18, 2011), http://www.forbes.com/sites/danielfisher/2011/07/18/nominee-cordray-had-solid-backing-from-securities-lawyers/.

[124] See Mayer Brown, "What to Expect from the CFPB: An In-House Perspective, Survey Results 2012," at 7, (2012), available at http://www.mayerbrown.com/files/uploads/Mayer_Brown_CFPB_Survey_Results.pdf.

[125] Andrew Erskine, "Legislative Fix for Consumer Financial Protection Bureau; Attorney Client Privilege Issue Remains in Limbo," *LawUpdate*. "[S]ome courts considering the waiver issue during this period held that the privilege was waived. Accordingly, many financial institutions resisted or hesitated to provide such information to the regulators."

institutions fear that the CFPB's ability to share this information with third-parties may later be asserted to have constituted a waiver of attorney-client privilege, enabling private litigants, such as class action attorneys, to gain access to those documents.[126] Moreover, although the CFPB has adopted internal rules governing the handling of these documents, the legal validity of those operating rules in the face of a court proceeding to force their surrender is open to question.[127] Legislation has been proposed that would close this gap, but it has not yet been passed.[128]

Even the one possible promising reform that could have emerged from the CFPB has already proven itself to be more of what came before: the rule on mortgage disclosures. As noted, the call for a simple mortgage disclosure process was a long overdue response to decades of legislation, regulation, and litigation piled on the mortgage disclosure process that has rendered mortgage documents lengthy and useless to ordinary consumers.[129] Instead, the proposed regulation—which weighs in at 1,099 pages—does little to help consumers by simplifying mortgage disclosures but imposes new substantive limits on loan terms, such as late fees, balloon payments, and loan-modification fees, while mandating new obligations by requiring high-risk borrowers in high-risk loan markets to meet with financial counselors before taking out a loan.[130] This entrenchment of continued regulatory complexity combined with new substantive limits

[126] For example, 80 percent of the respondents in the Mayer Brown Survey expressed this fear. Mayer Brown, *supra* note 124, at 6.
[127] Erskine, *supra* note 125. "Attorneys and others creating documents intended to be privileged should consider that not only are these documents likely to be available to the Bureau (as they are currently available to the prudential banking regulators for depository institutions), but also carry greater risk of being discovered by third party litigants and their attorneys, as the CFPB's position regarding nonwaiver is considerably less compelling than that of the prudential banking regulators."
[128] *Id.*
[129] See *supra* note 101 and accompanying text.
[130] See Jonathan Macey, "The Feds' New Mortgage Disclosures are Bust," *Wall Street Journal* at p. A15 (July 17, 2012), available in http://online.wsj.com/article/SB10001424052702303740704577527192635240670.html.

on loan terms and a resurgence of paternalistic regulation does not auger well for the CFPB's direction.

2. Misunderstanding the Real Causes of the Crisis Will Produce Unintended Consequences and Moral Hazard

A second substantive problem with the CFPB is that it rests on a badly flawed assumption about the causes of the financial crisis and the relationship to consumer protection policy. In particular, the animating premise of CFPB is Elizabeth Warren's assumption that the primary cause of the financial crisis was "dangerous" consumer credit products that involuntarily injured consumers by saddling them with overly complex and expensive mortgages (and presumably credit cards, payday loans, and other products) for which they did not understand the risks. Professor Warren even went so far as to compare mortgages that resulted in foreclosure to "dangerous toasters" that "explode" when used properly. As the argument goes, while consumers cannot buy a toaster that has a 20 percent chance of exploding, current federal law permits the existence of subprime mortgages that have a 20 percent likelihood of resulting in foreclosure.[131] Oren Bar-Gill and Elizabeth Warren have argued that consumer credit products can be dangerous in the same way as consumer appliances because consumer credit products are capable of causing substantial injury against which consumers are not equipped to protect themselves adequately: "Credit products should be thought of as products, like toasters and lawnmowers, and their sale should meet minimum safety

[131] Elizabeth Warren, *supra* note 1.

standards."[132] The solution proposed by Professors Bar-Grill and Warren was "the creation of a single regulatory body that will be responsible for evaluating the safety of consumer credit products and policing any features that are designed to trick, trap, or otherwise fool the consumers who use them."[133]

This over-simplified analogy completely misses the point. Unlike an exploding toaster, virtually every credit product—whether credit cards, mortgages, or payday loans—is suitable for some consumers in some situations but not for all consumers in all situations. More important, borrowers have substantial influence over whether their loans "explode" by the choices they make—if one in five toasters exploded because consumers chose to put them in the bathtub knowing what would happen, then that hardly is the problem of a faulty toaster. In fact, the analogy to the toaster in the bathtub is more apt than Warren's: Most foreclosures, for example, resulted from conscious choices made in response to incentives, not involuntary harm. For example, recent research indicates that those who took out "complex" mortgages were more sophisticated, had higher credit scores, and were more willing to strategically default subsequently than average.[134] Subprime lending and subsequent foreclosure rates were highest in those cities with the highest levels of real estate speculation and house-flipping.[135]

Certainly there were incidents of fraud and abuse by lenders during the housing boom that led to subsequent problems and consumers who misunderstood their lending products. Certainly there also were incidents of fraud and abuse by borrowers who

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[132] See Oren Bar-Gill and Elizabeth Warren, "Making Credit Safer," 157 *University of Pennsylvania Law Review*, 1, 6 (2008).
[133] Id.
[134] *Id.*
[135] See William C. Wheaton and Gleb Nechayev, "The 1998–2005 Housing 'Bubble' and the Current 'Correction': What's Different This Time?" 30(1) *Journal of Real Estate Research* 1, 15 (2008); Stan J. Liebowitz, "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown" (October 3, 2008), *Independent Policy Report* (October 3, 2008).

defrauded lenders. But there is no evidence that consumer protection issues were a substantial cause of the financial crisis as opposed to bad incentives.[136] The consumer side of the financial crisis (by which I refer to problems of high levels of default (on mortgages and credit cards) and foreclosure (on mortgages) was caused not by consumer ignorance but by misaligned incentives and rational consumer response to them.

Lenders made a huge number of loans that were clearly foolish in retrospect and perhaps should have been recognized as foolish at the time. These unwise loans presented, and continue to present, major problems for the safety and soundness of the American banking sector. But these loans were foolish *not* because consumers did not understand them. They were foolish because lenders failed to appreciate the incentives that rational, fully informed consumers would have to default on these loans if circumstances changed. In fact, millions of consumers have acted consistently with these incentives by walking away from their homes when they became bad investments.

Consider an extreme, but not unrealistic, scenario: A California borrower takes a nothing-down, interest-only, adjustable-rate mortgage to buy a new home in the far-flung exurbs of Southern California, planning to live in the house for a few years and then resell it for a profit.[137] Assume further that the borrower can continue to make his mortgage payment if he chooses to do so. Instead, the house plunges in value so that it is worth much less than the outstanding mortgage, and with widespread oversupply of housing there is no reasonable likelihood that it will come back above water in the near

[136] Of course, there were other issues implicated as well, such as the possible effect of governmental policies that forced or encouraged a growth in the number of risky loans through Fannie Mae and Freddie Mac, for example. I express no opinion on the possible role of those forces here.

[137] The most important kindling that started the housing crisis was the development of no-equity products, such as low down payment mortgages. See Kristopher Gerardi, Andreas Lehnert, Shane Sherlund, and Paul Willen, "Making Sense of the Subprime Crisis," in *Brookings Papers on Economic Activity*, 69 (Douglas W. Elmendorf, N. Gregory Mankiw, and Lawrence Summers eds., Fall 2008).

future. Under California's default-friendly anti-deficiency laws, the lender is limited to foreclosing on the house and cannot sue the borrower for the difference between the value of the house and the amount owed on the mortgage. As a result of all this, the homeowner crunches the numbers, consults his lawyer, and decides to stop making payments and allow foreclosure. He then buys or rents an identical home down the street for a fraction of the cost of his prior mortgage payment. During the pendency of the foreclosure action, however, the borrower can essentially live in the house rent-free, a period that in some places today can last as long as two to three years. If a consumer makes this financially savvy and rational choice, does that present a consumer protection issue?

Loans and laws that provide such strong incentives for consumers to rationally default instead of paying their mortgage present serious safety and soundness issues. Sensible regulatory policy should question whether banks should be permitted to make loans that provide such strong incentives for a borrower to default when the loan falls in value—or whether it is even sensible for states to have anti-deficiency laws. But while this scenario presents safety and soundness concerns, it does *not* present a consumer protection issue: When consumers rationally respond to incentives, that is not a consumer protection issue. The foreclosure in this hypothetical situation results from the set of incentives confronting the borrower and the borrower's rational response to them—empirical research indicates that loans with no down payment or which otherwise cause borrowers to have low or no equity in their homes (including interest-only, home equity loans and cash-out refinances) have proven to be especially prone to foreclosure in the recent crisis as stripping equity out of one's house makes it more likely that a price drop will push the house into negative equity territory, thereby providing incentives to default on the loan.

Economists model the homeowner's decision to default on an underwater mortgage as a financial "option" that consumers exercise consistent with the prediction of standard economic models.[138] In addition, economists find that when the value of exercising the foreclosure option rises (such as when the value of the underlying asset falls in value) or the cost of exercising the option falls (such as by the presence of an anti-deficiency law that reduces the cost to homeowners from default, especially high-income and high-wealth homeowners[139]), homeowners respond by exercising the option more readily.[140]

Rather than recognizing that the financial crisis resulted at least in some part from misaligned incentives that have created major safety and soundness issues, however, the CFPB operates on the premise that the financial crisis was produced by hapless consumer

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[138] See Joseph Adamson and Todd J. Zywicki, "The Law and Economics of Subprime Lending," 80 *University of Colorado Law Review*, 1 (2009) (discussing studies).

[139] Andra C. Ghent and Marianna Kudlyak, "Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States," (Working Paper, June 3, 2009); Lawrence D. Jones, "Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans," 36 *Journal of Law and Economics*, 115, 135 (1993).

[140] Lenders, of course, are well aware that debtor-friendly default laws raise the risk of lending and thus charge higher interest rates and lend less in states with debtor-friendly default laws. See Karen M. Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," 88 *Review of Economics and Statistics*, 177 (2006) (finding that average loan size is smaller in states with defaulter-friendly foreclosure laws); Jones, *supra* note 137 (higher down payments in states with anti-deficiency laws); Mark Meador, "The Effects of Mortgage Laws on Home Mortgage Rates," 34 *Journal of Economics and Business*, 143, 146 (1982) (estimating 13.87 basis point increase in interest rates as a result of anti-deficiency laws); Brent W. Ambrose and Anthony B. Sanders, "Legal Restrictions in Personal Loan Markets," 30 *Journal of Real Estate Finance and Economics*, 133, 147–48 (2005) (higher interest rate spreads in states that prohibit deficiency judgments and require judicial foreclosure procedures); Susan E. Woodward, U.S. Dep't of Hous. and Urban Dev., "A Study of Closing Costs for FHA Mortgages," 50 (2008), available at http://www.huduser.org/Publications/pdf/FHA_closing_cost.pdf (finding that presence of anti-deficiency laws raises costs of loan). But see Michael H. Schill, "An Economic Analysis of Mortgagor Protection Laws," 77 *Virginia Law Review*, 489, 512 (1991) (finding mixed results for impact of anti-deficiency laws on foreclosure rates depending on specification of regression).

victims being exploited and defrauded by unscrupulous lenders. Regulatory decisions based on a flawed understanding of the underlying phenomenon will undoubtedly have unintended consequences for consumers and, in fact, will likely exacerbate similar problems in the future.

Yet, astonishingly, the CFPB makes no acknowledgement of the reality that consumers respond to incentives and can create moral hazard problems of their own. So, for example, rather than acknowledging the important role played in many states by state anti-deficiency laws in fanning the foreclosure crisis, Dodd-Frank imposes new rules specially designed to protect anti-deficiency laws and ensure that homeowners retain the benefit of those laws, such as by being made expressly aware that they may lose the benefit of an anti-deficiency law by refinancing their homes.[141] This sort of special protection for anti-deficiency laws may or may not be wise as a matter of general policy—as noted above, empirical studies find that the presence of an anti-deficiency law raises the risk of lending, resulting in higher interest rates and other costs, as well as reduced credit access for borrowers. But one point is exceedingly clear: Anti-deficiency laws tend to increase the total number of foreclosures when home prices fall. Thus, if the goal of the CFPB is to reduce the number of mortgages that end in foreclosure, providing special protection for anti-deficiency laws will squarely contradict that goal, instead raising foreclosures when home prices fall.

Similarly, consider the role of prepayment penalties. Dodd-Frank bans prepayment penalties in most mortgages, presumably on the presumption that they are harmful to consumers and contributed to the foreclosure crisis for subprime mortgages,

[141] See 15 USCA § 1639c(g) (West 2012).

which often contained prepayment penalties (unlike prime mortgages).[142] But there is no evidence that prepayment penalties were excessively risky for consumers or that they systematically increased the risk of borrower default. In fact, evidence suggests that borrowers with subprime loans that contained prepayment penalty clauses were less likely to default than those without such clauses, perhaps because of the lower interest rate on loans with prepayment penalties or perhaps because the acceptance of a prepayment penalty provides a valuable and accurate signal of the borrower's intentions.[143] Borrowers pay a premium of approximately 20 to 50 basis points (0.2 to 0.5 percentage points) for the unlimited right to prepay. Subprime borrowers generally paid a higher premium for the right to prepay than prime borrowers because of the increased risk of subprime borrower prepayment and because the idiosyncratic nature of prepayment by subprime borrowers makes it more difficult to predict which borrowers will prepay.[144] Since mortgage lending has an asymmetric information problem—borrowers know more than lenders about their likelihood of prepaying—a prepayment penalty may also provide a credible signal by the borrower of his intent not to prepay the loan, thus overcoming an adverse selection in the marketplace and permitting a reduction in interest rates.

[142] See 15 USCA § 1639(c) (West 2012).

[143] Christopher Mayer, Tomasz Piskorski, and Alexei Tchistyi, "The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers," 36–37 (working paper, April 28, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108528. Sherlund also finds that the presence of prepayment penalties does not raise the propensity for default. Shane Sherlund, "The Past, Present, and Future of Subprime Mortgages," 5 (Federal Reserve Board, working paper no. 2008–63, September 2008), available at http://www.federalreserve.gov/pubs/feds/2008/200863/200863pap.pdf.

[144] See Adamson and Zywicki, *supra* note **Error! Bookmark not defined.**, at 18–20 (summarizing studies); Gregory Elliehausen, Michael E. Staten and Jevgenijs Steinbuks, "The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages," 60 *Journal of Economics and Business*, 33, 34 (2008) (reviewing studies); Mayer, Piskorski and Tchistyi, *supra* note 143, at 7–8 (reviewing studies). Term sheets offered to mortgage brokers similarly quoted interest-rate increases of approximately 50 basis points in those states that prohibited prepayment penalties.

In addition, the ability of American consumers to freely prepay and refinance their mortgages clearly exacerbated the current mortgage crisis—and banning prepayment penalties might thus exacerbate a similar situation in the future. When home prices were rising, many consumers refinanced their mortgages to withdraw equity from their homes. "Cash-out" refinancing became increasingly common during the duration of the housing boom—from 2003 to 2006, the percentage of refinances that involved cash-out doubled from under 40 percent to over 80 percent,[145] and among subprime refinanced loans in the 2006–2007 period, around 90 percent involved some cash out,[146] even though mortgage interest rates were rising during that period. In fact, even though there was a documented rise in loan-to-value (LTV) ratios between 2003–2007, even that may underestimate the true increase in the LTV ratio if appraisals for refinance purposes were inflated (either intentionally or unintentionally), as appraisals are a less accurate measure of value than actual sales.[147] This withdrawal of equity reduced borrowers' equity cushion, which meant that when home prices fell, these borrowers were much more likely to fall into a negative equity position, thereby making it economically rational to exercise the default option. The unique ability of American consumers to suck out their home equity through refinancing is a major reason why the foreclosure rate in the United States has been so much higher than in Europe, where prepayment (and hence cash-out refinancing) is generally prohibited. Thus, even though many countries in Europe

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[145] Luci Ellis, "The Housing Meltdown: Why Did It Happen in the United States," 22 (Bank for International Settlements BIS, working paper 259, September 2008), available at http://www.bis.org/publ/work259.pdf.

[146] Chris Mayer and Karen Pence, "Subprime Mortgages: What, Where, and To Whom," 16–17 (NBER, working paper no. 14083), available at http://www.federalreserve.gov/pubs/feds/2008/200829/200829pap.pdf.

[147] Ellis, *supra* note 145, at 22; Chris Mayer, Karen Pence, and Shane M. Sherlund, "The Rise in Mortgage Defaults," 6 (Federal Reserve, working paper, 2008–59, November 2008), available at http://www.federalreserve.gov/pubs/feds/2008/200859/200859pap.pdf.

(notably England) experienced a housing price bubble virtually identical to the United States', their foreclosure rate has been a fraction of ours, in part because restrictions on refinancing forced homeowners to retain the equity in their homes at the height of the boom, providing an equity cushion when prices later fell. As a result, many fewer homeowners had an incentive to walk away from their homes in Europe than in the United States.[148]

Thus, there is no evidence that the *presence* of prepayment penalties systematically increases foreclosures, primarily because acceptance of prepayment penalties results in more affordable loans and addresses adverse selection problems. On the other hand, the *absence* of prepayment penalties can increase foreclosures by providing opportunities to refinance and strip equity out of one's home. Thus, it is highly possible that the overall effect of banning prepayment penalties in mortgages will be to increase foreclosures and exacerbate a financial crisis similar to the last one. Nevertheless, Dodd-Frank expressly bans prepayment penalties without any apparent recognition of this possible unintended consequence—a decision that makes sense only when the reality is ignored that consumers respond to incentives and that failure to recognize this reality can create a moral hazard problem.

[148] Of course, this is not the only difference that explains why the foreclosure crisis has been so much more severe in the United States. Foreclosure laws are much tougher in Europe than in the United States: Anti-deficiency laws are unheard of and foreclosure is often more rapid and aggressive than in the United States, which in many states now takes two or three years during which consumers can live for free after they stop making payments. Also extremely important is that most mortgages in Europe are adjustable-rate mortgages, unlike in the United States, which is saddled with a disproportionate number of fixed-rate mortgages. In Europe, when the central bank cuts interest rates, this automatically reduces the interest rate for borrowers, making payment obligations more affordable and solidifying home values. Borrowers in the United States with fixed-rate mortgages, however, can benefit from lower interest rates only by refinancing—but those with negative equity in their homes will be unable to refinance without first coming up with a cash payment to make up the windfall. As a result, many hard-hit homeowners have been unable to refinance because of an inability to cover the closing costs and equity shortfall that would be necessary to do so. See Todd J. Zywicki, "The Behavioral Law and Economics of Fixed-Rate Mortgages (And Other Just-So Stories)," __ *Supreme Court Economic Review*, __ (forthcoming 2013).

D. Summary

The logic of the CFPB is flawed throughout. First, it creates a regulatory structure that ignores the findings of recent decades with respect to how to create an effective regulatory body. Second, instead of imposing structural checks that could mitigate these problems, it instead creates a structure that virtually guarantees the full manifestation of those defects. Finally, it fails to account for the real driving force in the breakdown of the efficacy of consumer financial problem—a runaway expansion of litigation and regulation—and instead promises more of the same. Moreover, it also fails to appreciate the underlying causes of the financial crisis itself—namely, that the defective loans were problematic because of misaligned incentives that caused safety and soundness, not consumer protection issues. By ignoring the reality that consumers respond to incentives, the proposed consumer protection reforms designed, for example, to reduce foreclosures, instead will likely have the effect of *increasing* foreclosures in the future. It is an open question as to whether it is optimal policy to adopt rules that can be predicted to increase foreclosures. But, in discussing whether this is wise, it does *not* make sense to believe that these policies are justified because somehow they will decrease foreclosures, when in fact the opposite result is more likely.

IV. The CFPB's Substantive Powers

A second major area of concern with the CFPB is the vast, ill-defined nature of the powers it is granted by Dodd-Frank. The CFPB has broad authority to engage in rulemaking, litigation, and to use other tools to further its mission. It has the power to regulate virtually every credit provider in America, including the most local pawn shops and payday lenders, and to impose massive penalties.

With respect to its substantive powers, perhaps the most threatening is its power to regulate "unfair, deceptive, and abusive" credit terms and products.[149] Although all three terms are vague and potentially expansive, the terms "unfair" and "deceptive" incorporate, at least as an initial matter, the definitions of those terms built up over a long period of time by the FTC. Nevertheless, as it goes forward, the CFPB also has the power to redefine those terms as it sees fit, thus this initial clarity may not be permanent.[150]

More problematic, however, is the power of the CFPB to regulate "abusive" terms and products. The term "abusive," as used in this context, appears to be an entirely novel term with no forerunners in any prior federal or state statute or regulation. Nor is there any legislative history to suggest what the term might mean.

The term "abusive" is defined by Dodd-Frank as follows in section 5531(d):

> ABUSIVE.—The Bureau shall have no authority under this section to declare an act or practice abusive in connection with the provision of a consumer financial product or service, unless the act or practice—
> (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
> (2) takes unreasonable advantage of—
>> (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
>> (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or

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[149] 12 USCA § 5536(a)(1)(B).

[150] *See "Consumer Laws and Regulations: Unfair, Deceptive, or Abusive Acts or Practices (UDAAP)," Consumer Financial Protection Bureau,* http://www.consumerfinance.gov/guidance/supervision/manual/udaap-narrative/. "Public policy, as established by statute, regulation, judicial decision, or *agency determination*, may be considered with all other evidence to determine whether an act or practice is unfair." (Emphasis added.)

> (C) the reasonable reliance by the consumer on a covered person[151] to act in the interests of the consumer.

It is not clear what this might mean, but a few things seem evident. First, it must mean something different from the terms "unfair" and "deceptive," because the term would be redundant otherwise. Second, the definition seems to be a discrete break with the philosophy that has animated the regulation of consumer credit for the past several decades—namely, a disclosure-based system designed to empower rather than displace consumer choice by harnessing the power of markets for consumers. The "abusive" standard, by contrast, appears to be a return to old-fashioned substantive regulation of early generations. Some have argued that "abusive" hearkens back to historic standards of unconscionability, which while once in vogue, have fallen out of favor in recent decades because of the inherent subjectivity of such a standard.[152]

One commentator, for instance, has summarized the abusive standard as empowering the CFPB to do three things:

> First, it seeks to make consumer choices more meaningful by simplifying contractual language. If contracts were clearer, consumers' consent would be more indicative of their actual preferences. Second, the "abusive" standard would give the CFPB power to modify products and take the most dangerous ones off the market entirely. Finally, the standard attempts to do what market forces alone may not: impose an explicit obligation on lenders to act in consumers' interest.[153]

[151] Dodd-Frank defines a covered person as: "(A) any person that engages in offering or providing a consumer financial product or service; and (B) any affiliate of a person described in subparagraph (A) if such affiliate acts as a service provider to such person." 12 U.S.C. § 5481(6).
[152] See Kate Davidson, "New 'Abusive' Standard Stokes Fear from Bankers," *American Banker* (September 5, 2011).
[153] Rebecca J. Schonberg, "The Meaning of 'Abusive' under Dodd-Frank: Fixing the Broken Market for Consumer Financial Products," 1 (working paper 2011), available at http://works.bepress.com/rebecca_schonberg/1.

If this interpretation of the "abusive" standard is true, then it would give the CFPB power to deem certain products inherently dangerous and remove them from the market—even if they were not "unfair" or "deceptive" and no matter how well the risks were disclosed and no matter how well the consumer understood the risk. Moreover, it would impose on the lender a duty of both *understanding* and acting in the "best interest" of the consumer. In this sense, the "abusive" standard could impose a sort of "suitability" standard on lenders, forcing them to determine whether certain products are appropriate for certain consumers or categories of consumers.[154] Thus, for the first time, it appears that under the "abusive" standard a lender might be required to understand paternalistically what is believed to be in the best interest of the consumer and act accordingly. It is easy to identify the straight line from the traditional paternalistic view of protecting "math-impaired females," who were thought to need special protection, to a new class of borrowers who are believed by regulators and lawyers to be unable to understand and act in their own best interests.

The broad definition of the "abusive" standard could have substantial implications for consumers and lenders, exposing the latter to potentially massive liability and chilling innovation of new products with the impact eventually being felt by consumers. What might "abusive" mean in light of the fact that it must mean something different from "unfair" and "deceptive"?

One definition is that it might permit the CFPB to ban contract terms that are justifiable under an efficient risk-based pricing rationale (and thus presumably not "unfair") but which the regulator believes that some consumers might find too confusing.

[154] See Davidson, *supra* note 152.

How this tradeoff would be determined without the type of analysis contemplated by the unfairness standard is not clear.

A second possible interpretation is potentially more pernicious—it could be read to create certain classes of consumers who are believed to be systematically less able to protect themselves than others. This would be the modern-day analogue to the "math-impaired females" of bygone days but with a new "protected" class of borrowers instead, such as the elderly, service members, or some other group thought to be stereotypically unable to fend for itself. Lenders could easily find themselves in a catch-22 if they determine that certain products are unsuitable for certain categories of borrowers, such as women, minorities, or the elderly. If so, taking the steps required to avoid liability for abusive lending could expose those lenders to potential liability under fair lending laws by withholding loans to certain groups.

A third interpretation might be one that allows the CFPB to ban products if it determines that, even though the products are completely transparently priced, are efficient under a cost-benefit analysis, and have terms that are understood by consumers, the regulator nevertheless believes that consumers (or at least some consumers) subjectively do not understand the risk. Of particular interest here might be the novel use of "behavioral economics" as a justification for regulation.[155] Consider a product such as payday lending, which among its terms permits borrowers to roll over their loans from one period to the next. Empirical research indicates that payday loan customers highly

[155] Dodd-Frank expressly bars the CFPB from imposing interest rate regulations on any consumer credit product, thus that approach to effectively banning certain products is not available.

value the option of rolling over their loans.[156] But so-called consumer advocates are often critical of the rollover option, arguing that it can create a "cycle of debt" for some borrowers. The rollover option is plainly not deceptive (all payday loan customers know about it) and is almost certainly not "unfair" (most borrowers seem to prefer to have the option). But the language of the abusive provision suggests that it might not matter whether consumers understand and value the rollover option if the CFPB decides that consumers systematically underestimate the likelihood of rolling over—i.e., that even though they say with confidence that they understand the risks and opportunities of the rollover option, the CFPB nevertheless thinks it should not be available because payday lenders might be taking "unreasonable advantage of a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service."

One could extend this logic to almost any non-traditional lending product. Auto title loans, for example, have an obvious risk that the borrower will lose his car, and borrowers obviously recognize this. In addition, most title pledge loan customers have more than one car and as many as half of the cars that are subject to repossession are older vehicles with fatal mechanical failures, suggesting that for most borrowers the adverse consequences of losing the car under the loan are muted.[157] How might the CFPB weigh these factors, just to name a few, in determining whether defaults are rational by consumers or the result of abusive practices? Nevertheless, could the CFPB ban title pledge loans as "abusive" even if not deceptive or unfair?

[156] See Todd J. Zywicki, "The Case against New Restrictions on Payday Lending," 2–3 (Mercatus Center, working paper no. 09–28, July 2009), available at http://mercatus.org/sites/default/files/publication/WP0928_Payday%20Lending.pdf.
[157] See Todd J. Zywicki, "Consumer Use and Government Regulation of Title Pledge Lending," 22 *Loyola Consumer Law Review*, 425 (2010).

This suggests that even though the CFPB cannot regulate interest rates (the traditional vehicle for regulating certain products off the market), it could regulate through the "abusive" standard virtually every other provision of consumer credit contracts and essentially abolish many of these products. The ability to deem certain products inherently unsafe or "abusive" is a dangerous one that will be likely to chill innovation and the introduction of new products.

Moreover, uncertainty about the meaning of "abusive" has been heightened by the confession of Richard Cordray that he will be unlikely to initiate rulemaking to define the term but instead is likely to define the term through enforcement actions. Given the ambiguity of the language itself and the novelty of the term, however, it will be very difficult for lenders to anticipate what actions may result in liability later. In addition to increasing predictability, rulemaking also enables impacted parties to participate in the required notice-and-comment proceedings for rulemaking. Enforcement actions also expose individual firms to bad publicity and the concentrated financial cost of defending the action, thereby driving targets to settle rather than to contest the action. But once a settlement is extracted, it often serves as a *de facto* rule guiding future behavior but lacking the due process protections of rulemaking.[158] For example, in a series of settled cases in the 1990s, the Department of Justice's prosecution of fair lending actions came to establish a *de facto* rule of applying "disparate impact" and "disparate treatment" to fair lending laws.[159]

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[158] See Thomas P. Vartanian, "Will CFPB Make Policy via Rules—or Enforcement?" *American Banker* (November 14, 2011).

[159] *Id.* Vartanian indicates that anti-money laundering and bank secrecy act cases also generally have been settled over the past decade, establishing *de facto* standards for the industry that are rarely tested in court and which have emerged without the protections of rulemaking procedures.

In addition, Dodd-Frank requires that if the CFPB does engage in rulemaking, it must consider the costs and benefits to financial service providers and consumers, "including the potential reduction of access by customers to consumer financial services."[160] The CFPB is also required as part of rulemaking to consult with prudential regulators, and its regulations may be set aside by the FSOC in certain circumstances.[161] These limits do not apply to the CFPB's civil investigatory, administrative, and litigation powers, however, creating an "internal agency bias" toward using enforcement and litigation instead of rulemaking.[162] Given the CFPB's unusual scope of authority to initiate civil litigation on its own, this tendency toward overuse of enforcement is exacerbated.

V. Preemption

A final area of incoherence in the CFPB is the preemption scheme established by the law. Indeed, Dodd-Frank creates a scheme of preemption (and reverse preemption, i.e., enabling state enforcement authorities to enforce federal law) that is an almost Platonic version of incoherence. On one hand, it empowers federal authorities to potentially reach down to regulate the operations of exceedingly local lenders (such as payday lenders) whose operations cannot conceivably have any spillover or externality effect on other states. On the other hand, it empowers state attorneys general to attack the operations of national banks and to also enforce the CFPB statute. Thus, rather than a coherent scheme of preemption, the CFPB instead imposes redundant enforcement

[160] Dodd-Frank section 1022 (b)(2)(A)(i).
[161] Vartanian, *supra* note 158.
[162] *Id.*

actions by state and local governments with no coherent division of authority but instead with seemingly only one purpose: maximizing litigation and enforcement.

To understand the incoherence of Dodd-Frank's preemption scheme, it is worth considering the initial rationale advanced for restricting preemption of state consumer protection laws. A common claim arising from the financial crisis was that federal bank regulators were "asleep at the switch" during the onset of the financial crisis, turning a blind eye to "predatory lending" by banks under its jurisdiction and preempting the efforts of state consumer protection enforcers to apply their laws. Furthermore, goes the story, the Supreme Court's decision in *Watters v. Wachovia* extended the power of the national bank regulators to preempt state law to subsidiaries and affiliates of nationally chartered banks, extending still further the number of institutions protected from state enforcement. One conclusion drawn from this history was that in light of the lack of aggressive and dedicated federal enforcement of consumer protection laws, it was necessary to withdraw some of the preemption authority of the federal government to enable state enforcers greater scope to enforce consumer protection laws.[163]

But even assuming *arguendo* that the argument for reduced preemption *might* have made sense prior to Dodd-Frank (a question that need not be resolved here), it no longer makes any sense whatsoever—because the centerpiece of Dodd-Frank was a new federal consumer protection super-regulator with massive powers to enforce consumer protection laws. Thus, if the argument for limiting preemption was predicated on the lack of federal enforcement, that argument no longer applies after the creation of the CFPB. So rather than state enforcers filling an arguable hole in the enforcement regime, Dodd-

[163] See Arthur E. Wilmarth, "The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services," 36 *Journal of Corporation Law*, 893 (2011).

Frank's scaling back of federal preemption piles state enforcement *on top* of federal enforcement. Thus, rather than under- or optimal levels of enforcement, Dodd-Frank adds the potential for over-enforcement by state regulators.[164] This concern about over-enforcement is especially troubling in the hands of politically ambitious attorneys general who may see an opportunity to promote themselves by redistributing wealth from out-of-state lenders to in-state consumers.

Even leaving these issues aside, the preemption rules and organizational structure of Dodd-Frank are contrary to any reasonable regime. A standard principle of regulation is that regulatory authority should reside in the level of government most suited to dealing with the regulatory problem—i.e., the national government should regulate issues with interstate spillovers and national effects, and the state government should regulate local matters for which the costs and benefits are concentrated in a given state. Dodd-Frank turns these propositions on their head. On one hand, Dodd-Frank peels back preemption and authorizes state officials to enforce regulations promulgated under Dodd-Frank, thereby unleashing state regulators to attack national banks. Because consumer finance operates in a national economy today, this will empower state regulators to interfere in interstate commerce and to externalize the costs of a particular state's rules on residents of other states. But on the other hand, Dodd-Frank also empowers the national government to regulate entirely local lending (such as payday lending), which has no plausible nexus to interstate commerce. It would be hard to imagine a less coherent interaction of state and federal regulation than that established by Dodd-Frank.

[164] An analogous situation arises with respect to so-called "Little FTC Acts" which duplicate the wording of the FTC Act but which in practice harm consumers and competition by piling on redundant enforcement on top of the measured enforcement and action of the Federal Trade Commission. See Henry N. Butler and Joshua D. Wright, "Are State Consumer Protection Acts Really Little-FTC Acts?," 63 *Florida Law Review*, 163 (2011).

As noted, Dodd-Frank reduces the scope of preemption. In addition, Dodd-Frank empowers state officials to enforce regulations promulgated by the CFPB.[165] Thus, even if the CFPB itself is conscious of the defects described above that raise concerns about its ability to create an efficient regulatory and enforcement policy, there remains the problem that excessive state enforcement could upset any balanced approach adopted by the CFPB. The legislation does require any state seeking to enforce CFPB regulation to notify the CFPB of its plan to do so[166] and permits the CFPB to intervene in any actions by state attorneys general to enforce CFPB regulations, presumably to explain to a court that it does not think that a particular action is consistent with the CFPB's position.[167] It does not empower the CFPB to actually veto actions by state officials to enforce CFPB regulations. But any restraint on state efforts to enforce regulations are likely to be fraught with political controversy, especially in light of the pronounced commitment of the CFPB to preserving an active role for state officials. Moreover, state officials can enforce CFPB regulations against any state-chartered entity, essentially enabling state officials to impose regulations that may be contrary to the policy choices of their state legislatures. Thus, it is unlikely that allowing redundant state enforcement of federal law will result in a balanced consumer protection policy.

VI. Conclusion: The Lessons of History Repeated

Washington responded to the financial crisis that began in 2008 with an onslaught of consumer finance regulation that has turned the market on its head. But while the regulation is new, the unintended consequences it has spawned are quite old. Through

[165] Dodd-Frank Wall Street Reform and Consumer Protection Act §1042(a)(1).
[166] *Id.* § 1042(b)(1).
[167] *Id.* § 1042(b)(2).

initiatives such as the Credit CARD Act of 2009, the Durbin Amendment to Dodd-Frank, and, finally and most importantly, the CFPB, Washington has systematically imposed punitive and ill-advised regulation and price controls on core consumer financial products: credit cards, debit cards, and mortgages. The results have been both predictable and tragic—systematically driving consumers out of the mainstream financial system, withdrawing high-quality products, and increasingly driving many consumers to inferior substitutes such as payday lending, overdraft protection, and prepaid cards. While those products play a valuable and necessary role in the consumer credit ecosystem, it is difficult to fathom the wisdom of government policies that systematically deter the use of preferred products and encourage the use of those alternatives. Still more frightening is the recognition that even as consumers have increasingly turned to these products as a lifeline to make ends meet, the CFPB stands poised to attack these products for doing exactly that.

This myopic vision ignores the lessons of history, both with respect to the history of regulatory policy and the regulation of consumer credit specifically. In the end, this regulatory onslaught will end as an economic matter where it has invariably ended in the past: in the recognition that excessive and unresponsive regulation raises the price and reduces access to high-quality credit and has harmed precisely those that it purportedly intends to help by depriving the most vulnerable consumers of choices, resulting in their turning ever more desperately to alternatives such as pawn shops and loan sharks. Just as well-intentioned credit regulation in the post-Depression era eventually spawned a thriving class of loan sharks, the current regulatory onslaught against credit cards and bank accounts has produced a thriving market for payday loans and pawn shops. Many consumers, especially lower-income consumers, have limited credit options already; a regulatory policy that raises the cost of lending to these consumers or deprives them still further of some of their currently limited choices is unlikely to be a strategy that will make their lives better. This is a conclusion shown again both by history and sound economics.

Equally tragic is that the creation of the CFPB reflects a squandered opportunity: an opportunity to update, improve, and bring coherence to the nation's consumer financial protection laws. Decades of regulation and litigation had created an encrustation of complexity and stasis on the consumer finance system, rendering the system unfriendly to consumers, competition, and innovation. Yet rather than sweeping away this sedimentary bed and creating a modern, dynamic regulatory scheme suited to a modern, dynamic industry, the CFPB returned to an archaic model of bureaucratic structure and regulation that was already considered outmoded forty years ago. Regrettably then, the CFPB's biggest cost might be a decade or more of lost opportunity as we re-learn the lessons that were taught so painfully in the 1970s.

In the hands of an agency with such radical design flaws as the CFPB, this is a recipe for disaster. Sensible reform proposals to the CFPB's structure have been proposed and should be adopted, sooner rather than later. In the meantime, we will re-learn the tragic lessons of history, both with respect to the institutional design of regulation as well as the dangers of wrong-headed consumer credit regulation.