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WHO'S WATCHING THE WATCHMEN? OVERSIGHT OF THE CONSUMER FINANCIAL PROTECTION BUREAU MAY 24, 2011

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It is my pleasure to testify this afternoon on the question of "Who's Watching the Watchmen? Oversight of the Consumer Financial Protection Bureau." This is a crucially important question to ask at a crucially important time in our economic recovery. Economic recovery remains fragile, housing markets are still in flux, and consumer credit markets are still recovering from the credit crisis and the imposition of regulations that have increased the cost and reduced the availability of credit to consumers and small businesses, from credit cards to bank overdraft protection. In addition, the Durbin Amendment to the Dodd-Frank financial reform legislation will take effect this summer, imposing confiscatory and punitive price controls on debit card interchange fees and shifting those costs onto American banking consumers. It is estimated that when the dust settles, these new banking fees will mark the end of free checking for low-income Americans and drive some one million of them out of the mainstream banking system and into the hands of check cashers, pawn shops, and fee-laden prepaid cards.[1]

This constant interference with the ability of lenders to price their risk accurately has resulted in higher interest rates, billions of dollars slashed from consumer credit lines, and record popularity for payday lenders and pawn shops.[2]

But these impositions are just the tip of the iceberg of the possible damage that poorly conceived regulation can do to consumer credit, small business credit, and the overall American economy. Just weeks from now the Consumer Financial Protection Bureau (CFPB) will enter its operative phase. If not subject to effective congressional oversight, the massive, vaguely defined powers and expansive reach of the new consumer credit "super regulator" could prove an economy killer, producing still-higher credit costs for consumers, and accelerating regulatory pressures that drive consumers out of the mainstream financial system and into the alternative, high-cost financial sector. Moreover, because millions of small,

[1] David S. Evans, Robert E. Litan, and Richard Schmalensee, *Economic Analysis of the Effects of the Federal Reserve Board's Proposed Deb it Card Interchange Fee Regulations on Consumers and Small Businesses* (Feb. 22, 2011).
[2] *See* Todd J. Zywicki, *Why Aren't Banks Lending? Because Bureaucrats and Politicians Won't Let Them*, WASHINGTON TIMES, page B1 (June 10, 2010).

independent businesses rely wholly or partly on personal and consumer credit to start and build their businesses, heavy-handed, misguided regulation could strangle job creation and economic dynamism.[3]

Indeed, based on standard economic analysis and the history of consumer credit regulation in America, an entirely foreseeable consequence of an unchecked CFPB will be—ironically—to produce higher levels of fraud and abuse of American consumers. This is because oppressive and misguided regulation stifles competition, reduces consumer choice, and drives consumers from the mainstream banking system into non-traditional lending products.

At this point, there seems to be a general consensus that the overall impact of the CFPB will be to increase the cost of, and reduce access to, consumer and small-business credit, and to increase the regulatory burden on financial institutions. Even supporters of the CFPB and its continued insulation from responsible oversight generally acknowledge that this will be the overall impact of the body as a purely descriptive matter—they simply believe that higher cost and reduced credit access to mainstream credit is a good thing in light of the experience of the past decade.

I disagree—economics and history teach that reducing *access* to credit does not reduce consumer *need* for credit. Washington bureaucrats cannot wish away the need of American families for credit. If you need $500 to repair your transmission to get to work on Monday, you need that $500 —regardless of whether you have a bank account or credit card. If you need $300 to pay your rent or electric bill, then you need that money regardless of whether you have it saved up or not. And if you can't get a credit card because a paternalistic Washington bureaucrat doesn't think you deserve one, then you are simply going to go to a payday lender. And if payday loans are regulated out of existence, you are going to turn to a pawn shop. History teaches the unfortunate lesson that if all else fails, illegal loan sharks stand ready to meet your needs.

Even if one believes that increasing the cost and reducing access to credit is a good thing, there should also be agreement that regulators should not try to increase cost and reduce access unduly. But the current organizational structure and lack of responsible oversight of CFPB creates an extreme danger that the agency will overreach, imposing costs on consumers, small businesses, and the economy that will stifle economic growth and drive vulnerable consumers into the arms of less-savory lenders. My testimony today will focus on some structural reforms that might help to minimize those unintended consequences.

At the outset, however, let me add one word—we have seen this movie before and we know how it ends. Beginning with the New Deal, central planners in the United States government created a flotilla of massive, unaccountable bureaucracies dedicated to micro-managing the American economy. And we know what happened: by the 1970s, these unaccountable regulatory behemoths had strangled the life out of the American economy—bringing about stagflation, reduced innovation, and declining American competitiveness--until the deregulation efforts, beginning with the Carter Administration and continuing through the Reagan Administration, restored dynamism to the American economy.

The structure of the CFPB is a throwback to this Nixon-era bureaucracy, from which we learned the following: you cannot give massive discretionary powers to unaccountable Washington bureaucrats, however well-intentioned, and expect they can run the American economy and still preserve innovation, competition, and consumer choice. That idea has been tried and has failed. Since that time, scholars have analyzed that historical experience to distill the general lessons of the pathologies that arise from

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[3] Thomas A. Durkin, *The Impact of the Consumer Financial Protection Agency on Small Business* U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, Sept. 23, 2009, http://www.uschamber.com/reports/impact-consumer-financial-protection-agency-small-business.

unaccountable bureaucrats tasked with a narrow tunnel-vision focus. I hope this body will take steps to avert the pain that will come from relearning those lessons.

I will focus on several different areas of possible reform to mitigate the damage that the CFPB will do to the economy: structural changes, increased accountability, and substantive changes to the agency's mission. At the outset, let me emphasize that I agree with the motivation underlying the creation of the CFPB—to create a more modern, coherent, and integrated consumer-protection regime for the regulation of consumer credit. Unfortunately, the CFPB is not likely to bring about this result.

Reforming the Bureau's Structure

H.R. 1121, passed by the House Financial Services Committee, would replace the single-director model of the CFPB with a multi-member commission. This is the most important reform that should be made to the bureau's structure to make it more consumer-friendly. Ideally, the entire bureau would be liquidated and sent to the dust bin of history, and all of its responsibilities sent to the Federal Trade Commission (FTC), where they belong. Absent that, however, the bureau should be reconstructed along the lines of the FTC as a multi-member commission, or the Board of Governors of the Federal Reserve should be given heightened oversight powers over the bureau.

The bureau's structure itself may be unprecedented in American history: an independent agency within another independent agency. Although headquartered within the Federal Reserve, it is almost completely unaccountable to oversight by the Federal Reserve Board or any other entity except through a cumbersome and limited oversight process by a council of regulators. But even this council can act only if two-thirds agree that a proposed action by the bureau would imperil the safety and soundness of the nation's financial system. Moreover, the bureau is headed by a single chief appointed by the President, rather than a multimember commission, leaving the agency's actions subject to the whims and idiosyncratic views of a single individual.

As an unaccountable bureaucracy with a single head, the bureau will be susceptible to bureaucracy's worst pathologies: a tunnel-vision focus on the agency's regulatory mission, undue risk aversion and agency overreach.[4]

Although a more effective consumer protection system is needed, consumer-protection goals often can conflict with other goals, such as promoting competition, lower prices and expanded choice for consumers; and ensuring safety and soundness of the banking system. Failing to account for the potential negative impact of overzealous regulation enacted in the name of consumer protection can result in greater harm to consumers in terms of higher prices, reduced choice, and lower quality services.

For example, the law gives the bureau new authority to regulate mortgage brokers, some of whom undoubtedly contributed to the onset of the financial crisis. Although stricter regulations of mortgage brokers theoretically could reduce fraud (although there is no evidence that this is the case), brokers also provide a salutary competitive check on traditional bank lenders. Research by economists Morris Kleiner and Richard Todd finds that overly restrictive regulation that reduces the number of mortgage brokers in a given market results in higher prices and lower quality for consumers—including a higher level of

[4] These bureaucratic tendencies have been well-documented by scholars over the past generation. For discussion *see* MAXWELL L. STEARNS AND TODD J. ZYWICKI, PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW (2009), especially discussion in chapter 6.

foreclosures.[5] An effective consumer-protection regulator must be able to balance consumer protection against other benefits to consumers and the economy of greater competition, lower prices, and enhanced safety and soundness. The current CFPB is not structured to weigh those broader trade-offs.

A better model is the Federal Trade Commission, the primary consumer-protection regulator for most of the American economy. At the FTC (where I was director of the Office of Policy Planning from 2003-04), the mission of the Bureau of Consumer Protection is virtually identical to that of the CFPB, focusing particularly on unfair and deceptive marketing. But the final decision on whether to act rests not with the director, but with the five-member bipartisan commission to which the bureau reports. Moreover, by combining under its roof the Bureau of Competition and the Bureau of Economics, the FTC has a broader scope to weigh the consumer protection bureau's narrow focus on consumer protection against the larger impacts on competition and economic efficiency (and vice versa).

Yet no one—least of all those who have worked at the FTC in recent decades—contends that this broader focus, greater accountability and internal checks and balances weaken the FTC's effectiveness as a consumer protection watchdog. Instead, FTC officials uniformly recognize that consumers benefit from lower prices and greater choice as well as consumer protection. I don't know a single FTC veteran who believes consumers would be better off if the director of the Bureau of Consumer Protection were unleashed to litigate and regulate without accountability to the commissioners. Yet that's precisely how the CFPB is structured. More generally, there is simply no good reason why this one agency, of all the similarly empowered agencies in Washington, should not be governed by a commission.

Increased External Accountability

The bureau should also have increased external accountability to Congress and/or the White House.

First, it is obvious that a bureaucracy with this huge budget and power should be subject to annual appropriations review and other traditional tools of oversight. There is simply nothing inherent in the functions of this bureau that should shield it from the same degree of transparency and democratic oversight as any other independent agency, such as the FTC or cabinet departments. I won't belabor this point as there is no serious argument against this regular degree of oversight.

Second, H.R. 1315, passed by the Financial Services Committee, would enable the Financial Stability Oversight Council to reverse decisions of the CFPB through a simple majority vote rather than the two-thirds majority needed under the current version of the law. This would provide a useful restraint on the bureau's inevitable tendency toward tunnel vision and mission overreach by providing some modicum of balance in the name of safety and soundness.

Third, the acts of the CFPB should be made subject to Office of Information and Regulatory Affairs (OIRA) or other external review for cost-benefit feasibility.[6] Independent agencies, including the Federal Reserve, traditionally have been exempted from OIRA review of their regulations. But that's because the internal deliberation process of a multi-member commission provides a collegial, deliberative process that ensures that all views are heard and all competing policies weighed. An agency headed by a single person, however, lacks these internal checks and balances. As a result, it is crucial that the decisions of

[5] Morris M. Kleiner & Richard M. Todd, "Mortgage Broker Regulations That Matter: Analyzing Earnings, Employment, and Outcomes for Consumers," in *Studies of Labor Market Intermediation*, David H. Autor, ed., University of Chicago Press, Nov. 2009.
[6] *See* John Morrall, Richard Williams, and Todd Zywicki, *The Next Hot Ticket in Financial Reform*, Reuters (Oct. 8, 2010), http://blogs.reuters.com/great-debate/2010/10/08/the-next-hot-ticket-in-financial-reform/.

the agency be reviewed by OIRA or some external analysts to ensure that the benefits of those regulations exceed the costs imposed.

Restrictions on Substantive Powers

The substantive powers of the CFPB should also be more sharply constrained than the broad and vaguely defined powers that are granted under its 400-page charter by the Dodd-Frank Act. Two areas are of particular concern. First, the bureau is empowered to regulate and punish not only "unfair" and "deceptive" lending practices, but also "abusive" loans and loan terms. This broad, vague, and retroactive standard will likely harm precisely those consumers it is intended to protect, and could dramatically raise the cost of lending by creating unpredictable retroactive liability. Second, the standard for preemption of contrary state laws should be returned to its prior level.

The CFPB has the power to regulate and punish not only "unfair" and "deceptive" lending practices (the FTC's standard) but also "abusive" loans and loan terms—a legal term that appears to be novel in this context. The contours of this new basis for liability are vague, but most obviously it must mean something different and more than attacking those products that are considered unfair or deceptive. In fact, it seems potentially to hold lenders responsible for a *subjective* standard of understanding and competency by some subcategories of consumers, or with respect to some subcategory of loan products.

For example, this power seemingly could enable the bureau to identify some groups of borrowers based on some crude demographic criteria as being thought too dumb to understand credit products that other consumers can understand and therefore have the option of using. Alternatively, the new super regulator would seem to have power to ban loan terms and products anytime the bureau chief thinks consumers lack the ability to comprehend the full risks of a product. The bureau chief could effectively ban many nontraditional lending products, such as payday lending, if he or she thinks, for example, that consumers using that form of lending are too dumb to appreciate the full cost and risk of those products—even if the consumers fully understand the risks and even though research shows that consumers overwhelmingly are satisfied with their choices and use payday loans because those loans are superior to other available choices.

Congress also should roll back the heightened standard for federal bank regulators to pre-empt state regulatory and enforcement authority over federally chartered banks. The threat addressed by pre-emption is long standing—the effort of populist state legislatures and politically ambitious prosecutors to score political points by attacking out-of-state federally chartered banks and their subsidiaries. But the consequences are heightened by the national character of the modern banking system, which has grown in large part because of the power of federal regulators to pre-empt parochial state laws. Moreover, if the rationale for heightened pre-emption standards is justified, it was because of a fear of inadequate federal enforcement—but that rationale was eliminated by the creation of the new federal bureau itself. Instead, the weakening of pre-emption threatens a nightmare regulatory dystopia: a new federal regulator that reaches down to the level of local payday lenders and small merchants while simultaneously empowering state regulators to attack national banks.

Market-Reinforcing versus Market-Replacing Regulation

There is a better way forward for consumers and the economy. Rather than a return to heavy-handed 1970s-style regulation, we should be moving in the direction of a new regulatory approach that harnesses the power of competition and technology to expand consumer choice and consumer welfare.

Consumer credit can be regulated in two different ways: either through "market-reinforcing" regulation or "market-replacing" regulation. Market-reinforcing regulation builds on the dynamism of the competitive process and consumer empowerment to make it easier for consumers to shop among competing credit products and choose the ones that are right for them. Without question, America's consumer credit regulatory system is ripe for a comprehensive overhaul. As a result of litigation and regulation, the Truth in Lending Act, for example, has evolved from a simple three-page document to a regulatory monster saddled with thousands of pages of regulation.[7] Clearing away this thicket of regulator and lawyer-imposed costs is necessary in order to make disclosure regulation work better for consumers. Defensive, legalistic disclosures designed to protect lenders from class action litigation based on technicalities rather than real harm has proven to be a major burden on the consumer finance system. Instead, the CFPB legislation unleashes class action lawyers and state attorneys general through its elimination of contracts to arbitrate, its heightened standards for preemption, and its coterminous power of state attorneys general to enforce federal law. This combination of new enforcement, with the vague, expansive sources of liability created by Dodd-Frank, are likely to spawn further regulatory confusion and defensive disclosures.

In addition, as noted, the regulatory process is plagued by redundant and oppressive regulation. The proposal for a single integrated mortgage disclosure form is a useful step in the right direction. Similar opportunities for streamlining and rationalizing the regulatory process could be seized—but are unlikely to emerge from this CFPB. Finally, recent decades have demonstrated the clunkiness of the old-style regulatory process. Today, innovations in consumer credit markets quickly outstrip the New Deal regulatory framework that exists. Once regulations are passed, they are too often set in stone; old regulations are almost never repealed. Instead, new regulations are simply piled atop existing regulation in an ever-mounting pile of incompatible and incoherent regulation. Finally, regulation in recent decades has been plagued by mandates regarding what I have referred to as "normative disclosure"—efforts to use disclosure not to help consumers to find the products that suit their needs, but instead to try to use disclosure to shape consumer preferences.[8] For example, a single, simplified mortgage disclosure form would be of substantial value to consumers—provided, of course, that more simplified consumer disclosure *forms* is not merely an effort to try to indirectly force more simplified *products* onto the market or to prefer the flawed idea of "plain vanilla" products to other types of products.

Today, for example, only about half of consumers use credit cards primarily as a credit device—others use it as a transactional device where they pay off their balance at the end of every month. Yet the regulatory framework requires credit card marketing to be focused primarily on the assumption that consumers will use it as a credit device. For the half of consumers who use the card like a debit card, however, this information is largely irrelevant. They care about benefits and other factors and compelled prominent disclosures of terms they don't care about simply makes it more difficult to find the information they do want. Furthermore, once imposed, regulations bear the permanent stamp of the particular issues of the day, which are soon obsolete as markets change.

Instead, CFPB is predicated on the old-style model of market-replacing regulation: the idea that Washington bureaucrats know better than real people what is good for them. Whether concealed under the guise of behavioral economics or "nudges" instead of mandates, the underlying premise is still the same—paternalistic bureaucrats who think they know better as to what credit products consumers should be allowed to buy and the terms under which they should be purchased. Again, we have seen time and

[7] *See* THOMAS A. DURKIN & GREGORY ELLIEHAUSEN, TRUTH IN LENDING: THEORY, HISTORY, AND A WAY FORWARD (2011).
[8] *See* Todd J. Zywicki, "The Market for Information and Credit Card Regulation," *Banking & Financial Services Policy Report*, Vol. 28, No.1, January 2009, pp. 13-16.

time again in history where this path leads: to higher credit prices, reduced choice, and harm to the very consumers that these regulations purportedly are intended to help.

Conclusion

The new CFPB promises higher costs and reduced access to credit for American consumers. The only question now is how much of an impact will be felt. Congress should take steps to build greater accountability and mission focus into a new consumer-protection regulator. Or consumers will be the losers in the end.