

# COMMITTEE ON CAPITAL MARKETS REGULATION

October 13, 2009

The Honorable Barney Frank  
Chairman  
House Financial Services Committee  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Spencer Bachus  
Ranking Member  
House Financial Services Committee  
2129 Rayburn House Office Building  
Washington, DC 20515

## Proposed Creation of a Consumer Financial Protection Agency

Dear Chairman Frank and Ranking Member Bachus:

The Committee on Capital Markets Regulation (“Committee”) has, since its establishment in 2005, provided empirical, independent research dedicated to improving the regulation of U.S. capital markets. In May 2009, the Committee published its report entitled, *The Global Financial Crisis: A Plan for Regulatory Reform*, setting out 57 recommendations for enhancing the soundness and effectiveness of the U.S. financial regulatory framework.<sup>1</sup> As part of its recommendations, the report sets out the Committee’s proposals for reforming the U.S. regulatory architecture to make it more robust and better designed to address the needs of investors and consumers of financial services. In this context, we felt that it would be useful to set out our position on the Administration’s proposal—presently embodied in H.R. 3126, the Consumer Financial Protection Agency Act of 2009 (Act)—that would establish the Consumer Financial Protection Agency (CFPA) as a dedicated agency for regulating and overseeing consumer protection issues in the provision of financial services. Where appropriate, we also make reference to the revised discussion draft of H.R. 3126 (revised discussion draft), proposing changes in the CFPA bill, circulated by Chairman Frank to the House Committee on Financial Services on September 22, 2009.<sup>2</sup>

From the outset, the Committee wishes to emphasize that establishing an independent regulatory agency for consumer and investor protection is one option the Committee believes deserves serious consideration; the other option, in our view, would be to incorporate this function as a division of a new consolidated regulatory agency. The Committee’s position on the Administration’s proposal, outlined below, is premised on the understanding that an independent agency would be created along the lines of H.R. 3126.

### I.

The Committee believes that the current state of fragmentation across the U.S. financial regulatory framework, evidenced by the operation of more than 100 different agencies regulating and supervising the financial markets, has given rise to an incoherent regulatory approach that has proved damaging and costly for the U.S. economy. Other advanced economies have moved toward a more consolidated regulatory model, with one or a very small number of regulators overseeing prudential and market regulation as well as consumer protection. The U.S. framework, however, remains wedded

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<sup>1</sup> A copy of our May 2009 Report can be downloaded from <http://www.capmksreg.org/research.html>.

<sup>2</sup> Since Roel C. Campos joined the Committee after the release of our January 14, 2009 statement on regulatory structural reform, which was the foundation for our treatment of this issue in the May Report and the basis for this letter, he did not participate in the writing of this letter. Robert Greifeld also did not participate.

to a sectoral focus unsuited to overseeing markets where participants, products and services do not fall neatly into the jurisdiction of one or other sector regulator. Moreover, despite this extensive proliferation of regulatory agencies, many important areas of the financial markets have been left without any coverage, or with coverage that is insufficiently rigorous to account for the risks they pose to the market and to the economy as a whole. We believe this is particularly evident in the case of consumer protection, where oversight is divided across multiple regulators (i.e., the Federal Reserve, the FTC, the SEC, NCUA, OCC, OTS, FDIC, DOJ as well as state regulators), resulting in a patchwork of supervision and enforcement of existing regulations as well as gaps in oversight for important sectors, notably mortgage origination outside the banking system and insurance, permitting abusive practices to flourish unchecked and to spread risk across the financial system.

In its report, the Committee recognizes the central importance of a robust and effective legal framework for overseeing consumer protection as part of an integrated financial regulatory structure. The Committee has proposed that the presently fragmented financial regulatory framework be consolidated into two or at the most three regulatory agencies. In addition to the continued operation of the Federal Reserve, the Committee envisages the creation of a U.S. Financial Services Authority (USFSA) as an overarching prudential and market regulator, akin to the U.K.'s FSA, Germany's BaFIN, or Japan's Financial Services Agency. One option suggested by the Committee is for the U.S. FSA to have a division devoted to investor and consumer protection. The head of the division would be Senate-confirmed to promote the importance of its function and independence within the overall agency. Alternatively, the Committee contemplated a second option in which investor and consumer protection would be part of a separate consumer/investor protection agency (CIP) while remaining prudential and market regulatory functions would be carried out by the USFSA. The first option ensures a comprehensive government assessment that balances different priorities including investor and consumer protection and the safety and soundness of financial institutions. The CIP option may lead to a more independent and vigorous approach to investor and consumer protection. We envisioned that any policy conflicts between the CIP and the USFSA would be resolved by the U.S. Treasury.

## II.

The Administration has taken a different approach from either option we recommended. First, it has not proposed to create a USFSA. Second, it has recommended creating the CFPA, which would have jurisdiction over only some areas of consumer protection and very little jurisdiction over investor protection.

Although the Treasury has promoted the CFPA as consolidating consumer protection in one agency,<sup>3</sup> we do not think that this is the case. Although the CFPA would be created as a dedicated agency for consumer protection, the Act does not fully consolidate oversight in its hands, with the SEC/CFTC retaining authority over consumer protection in the securities markets and state regulators continuing to have jurisdiction to regulate insurance contracts. The Act draws an unconvincing distinction between consumers of financial products and services, such as mortgagors, credit card holders, or payment services users on the one hand, and futures and securities investors on the other, with the latter subject to the rules of the CFTC and the SEC. The Act also gives states the authority to set consumer protection rules for insurance contracts, leaving an area with considerable consumer

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<sup>3</sup> Honorable Michael S. Barr, Assistant Secretary for Financial Institutions, U.S. Department of the Treasury, *Testimony to the U.S. Senate Committee on Banking Housing and Urban Affairs: Creating a Consumer Financial Protection Agency: A Cornerstone of America's New Economic Foundation*, July 14, 2009.

impact, to be generally regulated in accordance with the different legal regimes in place across the 50 states. It appears that the main reason for the incomplete integration of consumer and investor protection in one agency may be the same reason behind the lack of overall integration of the regulatory system—turf protection on the part of regulators and congressional committees, in part in response to the industries over which they have oversight.

### **A. Consumer vs. Investor Protection**

In view of the increasingly complex nature of financial products, where instruments can often overlap between functional categories (e.g., annuities can be both securities and insurance products and in turn may be linked to repayment on mortgage contracts), distinctions between “investors” and “consumers” of financial services are artificial, confusing for users and, in practical terms, unworkable. By way of example, a stockholder in a publicly-traded company would reasonably consider herself to be a “consumer” of financial services. Indeed, she may have taken out a loan from her bank to complete the stock purchase, and mortgaged her home to provide sufficient security for such a loan. To require that her stockholding be regulated differently from any loan or mortgage taken out to fund that purchase on the semantic basis that she is an “investor/purchaser” in the former case and a “borrower” in the latter is likely to create confusion for users of financial services as well as make for an inconsistent jurisprudence in the treatment of related financial products. Further, it is conceivable that CFPB-regulated products like credit cards could be used to make investments in the securities markets, for example, to purchase certain types of annuities.

A regulatory regime that is segmented among the CFTC/SEC, state regulators, and the CFPB on the basis of these classifications is likely to encourage both diverging regulatory standards in the treatment of similar financial products and regulatory arbitrage. For example, sellers may well be motivated to package products to bring them under a less exacting regulatory regime, irrespective of the economic characteristics of the products offered. This will not only mislead consumers but also encourage a “race to the bottom” in the quality of financial services provided to consumers. A USFSA, housing a division for consumer and investor protection, or an independent CIP, provides a fully consolidated alternative to the Administration’s current proposal, by regulating the full spectrum of financial products from the perspective of consumer/investor protection.

### **B. Safety and Soundness Considerations**

The Administration’s proposal limits the CFPB’s jurisdiction to financial products offered by banks and some non-banks other than insurance or securities firms. This would confine the scope of the agency’s consumer protection function to a subset of the full universe of financial products, in effect reducing the CFPB to principally a “banking consumer protection agency.” This is contrary to the Treasury’s justification of the CFPB as consolidating consumer protection in a single agency.

We want to emphasize that leaving consumer protection within the existing banking agencies is very problematic. These agencies have traditionally seen safety and soundness of banks as more important than consumer protection.<sup>4</sup> They are thus likely to shy away from consumer protection policies that will increase bank costs. This cannot be simply remedied by revising their mission statements.<sup>5</sup> Lodging consumer and investor protection in a financial services agency that is

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<sup>4</sup> Michael Taylor, *Twin Peaks: A Regulatory Structure for the New Century*. CSFI, London, December (1995).

<sup>5</sup> Compare Donald L. Kohn, Vice-Chairman of the Federal Reserve, *Testimony before the U.S. House of Representatives Subcommittee on Domestic Monetary Policy and Technology, Committee on Financial Services*, July 9, 2009.

responsible for much more than banking regulation would likely avert this problem. The case of the U.K. FSA is instructive. Consumer protection is one of the four statutory objectives of the U.K. FSA. Indeed, Charles Goodhart, a leading British economist, has argued that the U.K. FSA was established with a higher priority placed on consumer protection than safety and soundness or competitiveness.<sup>6</sup> To meet this statutory objective, the FSA requires firms to comply with extensive conduct of business rules<sup>7</sup> that stipulate very specific requirements with respect to the information to be provided to consumers, the format and frequency of the provision of such information, the duties of care owed to customers, procedures for managing conflicts of interest between firms and customers (for example, through mandatory best execution), dedicated consumer complaints processes and so on. In practical terms, the U.K. FSA has brought a number of disciplinary actions against wrong-doers for violations of consumer protection rules. Recent examples include proceedings to seek redress for more than one million consumers who lost money as a result of mis-sold personal pensions.<sup>8</sup> In the context of the current crisis, the U.K. FSA has been actively pursuing,<sup>9</sup> and taking disciplinary action against, firms and their officers found to have engaged in mortgage fraud and deceptive sales practices against consumers.<sup>10</sup>

The Administration has, in effect, proposed a consumer protection agency focused on products offered by banks, thereby ensuring a direct conflict between the policies of the banking regulators and the CFPA. The proposed legislation attempts to deal with this conflict by mandating that the five-member CFPA board include one representative from the banking regulators. This is not an effective mechanism to resolve conflict.

The revised discussion draft circulated by Chairman Frank creates a different system for resolving disputes. First, it creates a seven person Consumer Financial Protection Oversight Board composed of the chairmen of the three banking agencies, the Fed, OCC and FDIC, and the chairmen of NCUA, the FTC, HUD and the State Liaison Committee of the Federal Financial Institutions Examination Council (FFIEC). While this seven person board gives far more weight to banking regulators who, with NCUA, constitute a majority, the Oversight Board is prevented from exercising any executive authority. The director of the CFPA retains complete authority to exercise all executive and administration functions of the new agency. The five person board proposed by the Administration, in contrast, was contemplated to exercise executive and administrative authority via majority vote. So while banking regulators have more representation on the board under the Frank legislation, the board has less power to constrain the director of the agency. This is not a means to resolve the tension between consumer protection and other concerns and may give too much power to the director.

Second, the revised discussion draft creates a dispute mechanism that is triggered when the CFPA and a banking agency disagree. The bank's first step is to request a joint statement from both

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<sup>6</sup> Charles Goodhart and Eilis Ferran (eds) in *Regulating Financial Services and Markets in the Twenty-First Century* (2001), pp. 153-154.

<sup>7</sup> FSA Conduct of Business Sourcebook, FSA Handbook, available online at: <http://fsahandbook.info/FSA/html/handbook/COBS>.

<sup>8</sup> Financial Services Authority, *FSA on Track to Bring the Pensions Mis-selling Review to a Close*, January 28, 2002, available online at: <http://www.fsa.gov.uk/Pages/Library/Communication/PR/2002/010.shtml>.

<sup>9</sup> The Independent, *Brokers Fined and Banned in FSA Crackdown*, July 13, 2008, available online at: <http://www.independent.co.uk/money/mortgages/brokers-fined-and-banned-in-fsa-crackdown-866268.html>.

<sup>10</sup> For example, the Financial Services Authority, *FSA Fines and Bans Newcastle Home Loans and its Directors for False Information in Mortgage Applications*, August 4, 2009, available online at: <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/107.shtml>.

agencies resolving the conflict. If no agreement is reached within 30 days, the issue is appealed to a panel comprised of 3 representatives (1 from the CFPA and the banking agency, plus one from the agency then heading the FFIEC). That panel decides a resolution by majority vote within 30 days of the filing of appeal. Since the FFIEC is composed of banking or credit union regulators,<sup>11</sup> this would seem to give ultimate priority to safety and soundness concerns over those of consumer protection. While we believe the revised discussion draft is preferable to the approach of the Administration, it would be simpler, and perhaps more balanced, to assign dispute resolution authority to the U.S. Treasury.

### **C. Prohibition of Certain Products**

The CFPA has a very broadly defined power under section 1031 of the Act to take “any action...to prevent a person from committing or engaging in an unfair, deceptive or abusive act or practice...in connection with a consumer for a consumer financial product or service.” Section 1031 also provides the CFPA with rule-making authority to prevent acts and practices related to a consumer financial product or service that it considers to be unfair or deceptive. Going forward, the CFPA may seek to rely on this broad authority to ban the sale of complex products or those considered to present excessive risk for consumers. While the Act requires that the CFPA consult federal banking and other regulatory agencies before taking action under its section 1031 authority, we believe that this does not go far enough, given the very negative impact that prohibitory action taken under this section could have on the breadth of investment opportunities available to sellers and buyers in the financial markets, thereby affecting their risk management strategies as well as their appetite for new and innovative financial products. We recommend that where the CFPA seeks to ban products that it considers to be excessively risky, procedures must be put in place to ensure that this is only carried out after a much more thorough review than is currently contemplated in the Act, a full cost benefit analysis and “super-majority” voting (we would recommend a 4-1 majority) in favor of a ban. This added safeguard would ensure that the CFPA’s decisions in these cases are strictly vetted, necessary and proportional to meet the agency’s objectives.<sup>12</sup>

### **D. Reverse Pre-emption**

Another concern with the Administration’s proposal involves its significant weakening of the pre-emptive effect of federal consumer regulation on state regulation. Currently, most state consumer regulation of national banks (generally the largest and most important banks) is pre-empted by federal regulation pursuant to the National Bank Act, which traces its origin to the creation of national banks during the Civil War. While the Supreme Court in March 2009 trimmed the outer edges of such pre-emption in *Cuomo v. Clearinghouse Association*,<sup>13</sup> such pre-emption is still very extensive.

The proposal would discard federal pre-emption entirely and permit state regulation that is more protective of the consumer than the federal CFPA regulation, in effect reverse pre-emption. This will significantly increase the costs for national banks whose business will have to conform to different state rules. While a case for such action could be made if consumer protection had continued to be lodged in banking agencies that made it a secondary priority, this concern should disappear with

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<sup>11</sup> The FFIEC would be composed of the FDIC, Fed, OCC and NCUA, plus a state bank regulator.

<sup>12</sup> We do not comment on the Administration’s plain vanilla proposal, whereby any financial institution offering a complex product would also have to offer a “plain vanilla” product, since this proposal has been dropped from Chairman Frank’s revised discussion draft.

<sup>13</sup> 129 S.Ct. 2710 (2009).

the creation of a new strong and independent CFPA. Indeed, the creation of such agency should result in stronger not weaker federal pre-emption.

**E. Greater Accountability**

Finally, we would recommend that the CFPA, if approved by Congress, have a governing structure similar to that of the SEC and the CFTC. Accordingly, we believe that the CFPA be organized as a Commission with a 3-2 party split between commissioners. This should best ensure politically responsible governance and an institutional check on excess, by underscoring unanimity and consensus in decision-making.

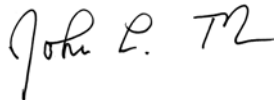
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Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

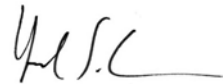
Respectfully submitted,



R. Glenn Hubbard  
Co-CHAIR



John L. Thornton  
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Hal S. Scott  
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cc: Members of the House Financial Services Committee