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CREATING A CONSUMER FINANCIAL PROTECTION AGENCY: A CORNERSTONE OF AMERICA'S NEW ECONOMIC FOUNDATION

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

THE CREATION OF A CONSUMER FINANCIAL PROTECTION AGENCY TO BE THE CORNERSTONE OF AMERICA'S NEW ECONOMIC FOUNDATION

JULY 14, 2009

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CREATING A CONSUMER FINANCIAL PROTECTION AGENCY: A CORNERSTONE OF AMERICA'S NEW ECONOMIC FOUNDATION

TUESDAY, JULY 14, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:05 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order.

I would like to welcome all here this morning for this morning's hearing on "Creating a Consumer Financial Protection Agency: A Cornerstone of America's New Economic Foundation." We want to thank you, Mr. Barr, for joining us, and our other witnesses we will hear from after your testimony, and the Members of the Committee who are here this morning. And, obviously, my good friend and colleague Richard Shelby, former Chairman of the Committee, will be making some opening comments as well. So let me take a few minutes and share with you my thoughts on this question and then turn to Richard for any comments he has. And since only a few of us are here this morning, Bob, if you have got any opening comments you would like to make as well, I will turn to you, and then we will go to you, Mr. Barr, for your testimony.

This morning we are taking an important step in our efforts to modernize our financial regulatory system. The failure of that system in recent years has left our economy in peril, as we all know, and caused real pain for many hard-working Americans who did nothing wrong themselves. And so I would like to start by reminding everyone that the work we do here matters to real people, men and women in my home State of Connecticut and all across our Nation who work hard every day, play by the rules, and want nothing more than to make a better life for themselves and their families.

These families are the foundation, as all of us know, of our economy and the reason that we are here in Washington working on this historic and critically important legislation. That is why the first piece of the Administration's comprehensive plan to rebuild our regulatory regime and our economy is something that I have championed as well, and that is, an independent agency whose job it will be to ensure that American consumers are treated fairly and honestly.

Think about the moments when Americans engaged with financial service providers. Now, I am not talking about big-time investors or financial experts. We know those people have a level of sophistication. I am talking about just ordinary citizens, working people trying to secure a stable future for themselves and their families. They are opening checking accounts. They are taking out loans. They are building their credit. They are trying to build a foundation upon which their families' economic security can rest for years to come. These can be among the most important and stressful moments a family can face.

Think of younger people who have carefully saved up for that down payment on a home. It might be a modest house, but it will be their first home, a starter home. Before they can move into their new home, however, they must sign on the dotted line for that first mortgage, with its pages and pages of complex and confusing disclosures. Who is looking out for them in that process?

Think of a factory worker who drives 30 miles to and from work every day and that old car that is about to give out. He or she needs another one to make it through the winter, but wages are stagnant and the family budget is stretched to the max. He has got no choice but to go to navigate the complicated world of an auto loan. Who is looking out for that person at that moment?

Think of a single mother—and there are many in our country—whose 17-year-old son or daughter has just gotten into his or her first choice of going to college. She is overjoyed for him or her, but worried about how she is going to pay for that tuition, which grows every year astronomically. Financial aid might not be enough, and she knows that as her son or daughter begins the next chapter in their lives filled with promise, they may be saddled with overwhelming debt. Who is looking out for that family under those circumstances?

These moments are the reason that we have invested so much of our time and money to rebuild our financial sector, even though some of the very institutions that the taxpayers have propped up are responsible for their own predicaments. These moments are the reason why we serve on this Committee and why I believe we have all come to the Senate to try and make a difference in the lives of the people we represent. And these moments are the reason that I and many of my colleagues were enraged by the spectacular failure of consumer protection that destroyed economic security for so many of our American families.

In my home State of Connecticut and around the country, working men and women who did nothing wrong have watched this economy fall through the floor, taking with it their jobs, their homes, their life savings, and the cherished promise of the American middle class. These people are hurting. They are angry and they are worried, and they are wondering whether anyone is looking out for them.

Since the very first hearings before this Committee on modernizing our financial regulatory structure, I have said that consumer protection should be a top priority in our deliberations. Stronger consumer protection could have stopped the crisis before it started, in my view. And where were the regulators in all of this?

We know now that for 14 years, despite a clear directive from the U.S. Congress, the Federal Reserve Board took no action to ban abusive home mortgages. Gaping holes in the regulatory fabric allowed mortgage brokers and bankers to make and sell predatory loans to Wall Street that turned into toxic securities and brought our economy to its knees.

That is why many of us call for the creation of an independent consumer protection agency whose sole focus is the financial well-being of consumers, an agency whose goal it is to put an end to lending practices that have ripped off far too many American families, and the Administration has sent us a very bold and I believe thoughtful plan for that agency.

You would think financial services companies would support protections that ensure the financial well-being of their consumers. An independent consumer protection agency can and should be very good for business, not just for consumers. It can and should protect the financial well-being of American consumers so that businesses can rely on a healthy customer base as they seek to build long-term profitability. It can and should eliminate the regulatory overlap and bureaucracy that comes from the current Balkanized system of consumer protection regulation. It can and should level the playing field by applying a meaningful set of standards, not only to the highly regulated banks but also to their nonbank competitors that have slipped under the regulatory radar screen.

Financial services companies that want to make an honest living should welcome this effort to create a level playing field. Indeed, the good lenders—and there are many—are the most disadvantaged when fly-by-night brokers and fly-by-night finance companies set up shop down the street. Then we see bad lending pushing out the good.

No Senator on this Committee, Democrat or Republican, wants to stifle product innovation, limit consumer choice, or create regulation that is unnecessary or unduly burdensome. And I welcome the constructive input from those in the financial services sector—who share our commitment, by the way, to making sure that American families get a fair shake. We all want financial services companies to thrive and succeed, but they are going to have to make their money, in my view, the old-fashioned way: by developing innovative products, pricing competitively, providing excellent consumer service, and engaging in fair competition on the open market.

The days of profiting from misleading or predatory practices need to be over with completely. The path to recovery of our financial services companies and our economy is based on the financial health of American consumers. I believe that very deeply. We need a system that rewards products and firms that create wealth for American families, not one that rewards financial engineering that generates profits for financial firms by passing on hidden risks to investors and borrowers.

The fact that the consumer protection agency is the first legislative item the Administration has sent to Congress since it released its white paper on regulatory reform last month tells me that our President's priorities are in the right place. Nevertheless, with the backing of the Administration, with the support of many in the financial community who understand the importance of this reform,

and, most of all, with a mandate from the American families I have discussed who count on a fair and secure financial system, I believe that we will push forward and succeed.

I thank all of you for being with us here today as we move forward on this issue. Let me say, as I have said many times already in discussions both informally and formally, Richard Shelby, my partner in all of this, he and I are determined to work together on this to get this right. This is not one where we bring a lot of ideology to this debate but, rather, what works, what makes sense, what will restore the confidence and optimism of people all across this country—and, for that matter, around the world, who look to the United States as a safe and secure place and an innovative place to come and park their hard-earned dollars and hard-earned money.

And so, with that, I thank again everyone for being here, and let me turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

The Committee today, as the Chairman has already said, will examine the Administration's proposal to establish a stand-alone consumer protection agency. Well-regulated and transparent financial markets have been and must continue to be one of the central goals of our financial regulatory system. The purpose of our markets is to benefit consumers by giving them ways to save, invest, and conduct transactions.

Consumers are not likely to participate in our markets, however, unless they know they are protected against fraud and unfair dealings. In addition, consumers are more likely to use financial products if they have the information they need to make good financial decisions.

By creating confidence in our markets, consumer protection promotes consumer participation, which in turn provides additional benefits by increasing the size, vitality, and resilience of our financial system. Good consumer protection, therefore, makes good economic sense.

Since the start of the ongoing financial crisis, I have stated that we should approach regulatory reform in a thorough and deliberate manner. I believe this Committee should examine what caused this financial crisis, develop solutions to the problems identified by that examination, and then consider the practical consequences of any reform measures.

This morning, we begin our examination of the Administration's proposal. This is our first chance to review the Administration's findings regarding the problems they have identified and the solutions that they seek. As part of our consideration, I believe it would be very useful, if not necessary, for the Administration to submit for the record the data and the evidence they used to craft a regulatory restructuring proposal. It might be very helpful to us here.

In addition, the fact that the Administration has produced a legislative draft gives us a chance to consider some of the practical questions associated with the proposal. For example, how will this new agency interact with the other banking regulators? Who will have the final discretion over things like capital treatment for al-

ternative mortgage products or other consumer credit products? What authority would the Administration leave to State banking regulators?

What if there is a disagreement between a prudential supervisor and the new consumer protection agency? What if a prudential supervisor fails to operate in a manner consistent with the consumer protection agency's guidelines? Will a prudential supervisor be allowed to overrule the consumer protection agency?

Will certain types of financial products be banned? What standards would be used to make the decision to remove products from the marketplace?

Beyond the practical issues regarding the program, I want to highlight some conceptual issues that I believe we must recognize as we consider financial consumer protection reform.

First, I believe that we must clearly acknowledge and accept that risk cannot be eliminated from our financial markets? It is risk taking that generates return. It would be both false and irresponsible to lead the American people to believe that an enhanced regulator can provide them with risk-free opportunities.

Second, I believe that we must also acknowledge that the risk associated with financial products are largely depending on the circumstances surrounding a particular transaction and the consumer. Some have tried to make oversimplistic analogies comparing defective consumer products to certain financial products. This is inaccurate, and I believe it is highly inappropriate.

For example, a defective electrical device is dangerous under every circumstance where it is used. We know that. But that is not the case for financial products. A plain-vanilla 30-year fixed mortgage is not inherently safer, some argue, than a shorter adjustable rate product? In fact, a 30-year fixed mortgage could involve high costs and provide less value to the consumer. We have to look at the circumstances.

Consumers need the relevant information and the means to understand it so they can purchase products and engage in the transactions that best fit their needs and circumstances. This point bears on what I believe is finally the most important issue associated with consumer protection reform. Who is best able to decide about the value and the necessity of any particular financial product or service?

Some, including those in the Administration, have decided that consumers will not act in their own best interests and, therefore, it is necessary that we remove or greatly restrict products that in some situations might cause financial harm. Implied in this belief is the notion that some people, such as the Government bureaucrats, can make informed decisions about the value of products and services while others, such as the American consumer, cannot. In other words, "Yes, we can," has become "No, you can't."

While I can accept the view that in some cases consumers do not have the necessary information or understanding to make sound financial decisions, I do not accept the premise that the remedy is to deny consumers decision-making power altogether. I think this would be a very significant and paternalistic departure from the notions of liberty and personal responsibility that have previously guided all our regulatory efforts. Quite frankly, I find it a bit dis-

turbing and somewhat offensive that the concept of the "intellectually deficient consumer" has now found a voice in our legislative process.

To the extent that there is any merit to this theory, I believe it would be better to provide those with deficiencies the means to address them rather than seizing from them their right to make free and informed choices. And while I look forward to hearing from our witnesses, I am greatly concerned over many aspects of the President's plan, not to mention its underlying premise.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

And with that, we will turn to you, Mr. Barr, for your opening statement and any supporting material or data you think would be valuable for the Committee to have at this point. Why don't you go ahead? Try and keep your remarks down, if you can, to 5 or 10 minutes or so.

STATEMENT OF MICHAEL S. BARR, ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS, DEPARTMENT OF THE TREASURY

Mr. BARR. Certainly. Thank you very much, Chairman Dodd, thank you very much, Ranking Member Shelby. It is a pleasure to be back here to talk with you about the Administration's proposal for a Consumer Financial Protection Agency, a strong financial regulatory agency charged with just one job: looking out for consumers across the financial services landscape.

The need could not be clearer. Today's consumer protection system is fundamentally broken. It has just experienced a massive failure. This failure cost millions of responsible consumers their homes, their savings, and their dignity. And it contributed to the near collapse of our financial system.

There are voices today saying that the *status quo* is fine or good enough, that we should just keep the bank regulators in charge of protecting consumers, that we just need some patches to our broken system. They even claim consumers are better off with the current approach. It is not surprising that we are hearing these voices.

As Secretary Geithner observed last week, the President's proposals would reduce the ability of financial institutions to choose their own regulator and to continue financial practices that were lucrative for a time, but that ultimately proved so damaging to households and our economy. Entrenched interests resist change always. Major reform always brings out fear mongering. But responsible financial institutions and providers have nothing to fear.

We all aspire to the same objectives for consumer protection regulation: independence, accountability, effectiveness, and balance. The question is how to achieve them. A successful regulatory structure for consumer protection requires a focused mission, marketwide coverage, and consolidated authority.

Today's system has none of these qualities. It fragments jurisdiction for consumer protection over many regulators, most of which have higher priorities than protecting consumers. Nonbanks avoid Federal supervision; no Federal consumer compliance examiner lands at their doorsteps. Banks can choose the least restrictive supervisor among several different banking agencies with respect to

consumer protection. Fragmentation of rule writing, supervision, and enforcement leads to finger-pointing in place of action and makes the action that is taken less effective.

The President's proposal for one agency, for one marketplace with one mission—to protect consumers—will change that. The Consumer Financial Protection Agency will create a level playing field for all providers, regardless of their charter or corporate form. It will ensure high and uniform standards across the financial services marketplace. It will end profits based on misleading sales pitches and hidden fee traps, along the lines of those that Senator Shelby and Chairman Dodd worked together to end in the credit card market. But there will be plenty of profits made on a level playing field where banks and nonbanks can compete fairly on the basis of price and quality.

If we create one Federal regulator with consolidated authority, we will be able to leave behind regulatory arbitrage and interagency finger-pointing. And we will be assured of accountability.

Our proposal ensures, not limits, consumer choice; it preserves, not stifles, innovation; it strengthens, not weakens, depository institutions; it will reduce, not increase, regulatory costs; and it will increase, not reduce, national regulatory uniformity.

Successful consumer protection regulation requires mission focus, marketwide coverage, and it requires expertise and effectiveness through a consolidated supervisory entity.

Consumer protection requires a mission focus for accountability, expertise, and effectiveness.

A new supervisor must have marketwide jurisdiction to ensure consistent and high standards for everyone.

And an effective regulator requires authority for regulation, supervision, and enforcement to be consolidated. A regulator without the full kit of tools is frequently forced to choose between acting with minimal effect and not acting at all. We need to end the finger-pointing. The rule writer that does not supervise providers lacks information it needs to determine when to write or revise rules and how best to do so. The supervisor that does not write rules lacks a marketwide perspective or adequate incentives to act. Splitting authorities is a recipe for inertia, inefficiency, and lack of accountability.

The present system of consumer protection is not designed to be independent or accountable, effective, or balanced. It is designed to fail. It is simply incapable of earning and keeping the trust of the American people.

Today's system does not meet a single one of the requirements I just laid out. The system fragments jurisdiction and authority for consumer protection over many agencies, most of which have higher priorities than protecting consumers. Nonbanks avoid Federal supervision; banks can choose the least restrictive supervisor; and fragmentation of rule writing, supervision, and enforcement leads to finger-pointing in place of action.

This structure is a welcome mat for bad actors and irresponsible practices. Responsible banks and credit unions are forced to choose between keeping market share and treating consumers fairly. The least common denominator sets the standard, standards inevitably erode, and consumers pay the price.

Mr. Chairman, if you look at the range of problems that have been occurring in the marketplace through this fragmented jurisdiction, I think that it is clear that the American public cannot afford more of the same. The problems that we had in the mortgage market—exploding ARMs, rising loan balances, credit card tricks such as double-cycle billing and late fee traps, the extent of failures in the past—are just unacceptable for us in the future, and the system we have had that led to this is structurally flawed. It is not capable of being fixed through tinkering around the edges. The problem is the structure itself.

That problem has only one effective solution: the creation of one agency for one marketplace with one mission—to protect consumers of financial products and services, and the authority to achieve that mission.

It is time for a level playing field for financial services competition based on strong rules, not based on exploiting consumer confusion. It is time for an agency that consumers—and their elected representatives—can hold fully accountable. The Administration's legislation fulfills these needs.

Thank you for this opportunity to discuss our proposal, and I would be happy to answer any questions.

Chairman DODD. Well, thank you very much, and I did not give you a proper introduction to begin with, and I apologize. Mr. Barr is the Assistant Secretary for Financial Institutions at the Department of Treasury, and I should have made the formal introduction, so forgive me for not doing so.

Mr. BARR. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much for your testimony. As I said at the outset, if you have any additional data that you think would be helpful for the Committee in its consideration, we would appreciate your submitting that to us as well. And I will ask the clerk to put us on a 5-minute clock, if you would here, and we will try and stay to that time.

Let me, if I can, be sort of the devil's advocate with you because I anticipate these sorts of questions will be raised by my colleagues as well. I know you have spent a lot of time in your testimony on this point, but I think it is worth reiterating. Why do you think a separate consumer protection agency is necessary? And why wouldn't we just simply beef up the existing regulatory bodies? Let us even assume we end up consolidating a number of these regulatory bodies so they are far more efficient, we stop the regulatory arbitrage that is going on too often, the shopping, the charter shopping that we talked about. Why not just beef them up, give them additional personnel, and tell them they ought to be doing a better job? In effect, aren't they supposed to be consumer protection agencies in their own right? And so why in the world would you go around and create a whole new one? And wouldn't you, in fact, be then minimizing the importance of these other bodies if they end up deferring that consumer protection function to one agency and they are not doing the job they were supposed to be doing in addition to their regulatory functions?

Mr. BARR. Thank you, Mr. Chairman. I think we have had a long experiment with having the prudential supervisors over banks responsible for consumer protection supervision, having another

agency—the Federal Reserve—responsible for rule writing, having yet another agency—the Federal Trade Commission—responsible for after-the-fact enforcement in the nonbanking sector. And I think what we have seen and what the American public has just experienced is a massive failure of that system. And it was a massive failure of that system because of the very structure of the system.

There were good people at the Federal Reserve, for example, who wanted to effectuate strong consumer protections. You might even say there were heroic people at the Federal Reserve who wanted to effectuate consumer protection. Ned Gramlich, who was a dear friend of mine, the Vice Chair of the Federal Reserve, wanted to get consumer protection done, and the very structure of the Federal Reserve, its very focus on what it viewed as prudential supervision, its inability to move quickly on consumer protection blocked reform in the mortgage market that could have helped avert this crisis.

So I think we have had a long and disastrous experience with having bank agencies with a mixed mission, with no one focused on protecting consumers, with no one able to set rules and supervise across the financial services marketplace, with no one able to say there is going to be a level playing field with high standards for everybody. And what we saw is the market tipped to bad practices. We saw it tip to bad practices in credit cards, practices which you and Mr. Shelby so effectively blocked in the credit card bill this spring. We saw it shift, tilt to bad practices in the mortgage market in ways that were disastrous for the American people. And I just don't think we can afford that experiment any longer. We have to have a fresh start with a new agency whose sole mission is standing up for the American people.

Chairman DODD. Let me continue my role as the devil's advocate. One of the arguments we are going to hear is this will restrict the availability of credit to consumers, restrict their choices; that a way that the financial institutions will respond to this is just start saying no to a lot of people who otherwise might have a chance to get that car loan, get that started house; and so if you want us to make sure we are not going to make any mistakes at all, not take any risks at all, then we just won't provide that kind of extension of credit to an awful lot of people out there.

How do we respond to the question that consumer credit and consumer choices are going to be severely limited if, in fact, you get so heavy-handed with a consumer protection agency that the very people you are designing it to help here are actually going to be hurt by this idea?

Mr. BARR. Mr. Chairman, I think that is exactly the thing to be focused on, and in our legislative draft, we suggest that the agency be required to assess not just the benefits of its rules, but the costs of its rules; that it be required not just to look at questions of consumer protection but also questions of access; that it be required to evaluate its major rule writing every 5 years to ensure that it is keeping up with changes in the marketplace at a minimum; that it be required to be held accountable through notice and comment rulemaking, even when it is not going to do a rule, to let the public and financial institutions comment on how it is doing its job.

I think it has got to weigh the costs and the benefits. It has got to be a balanced entity. But what we want to see is a level playing field, access for everyone based on high standards. We want consumers to be able to choose whatever product they want, whatever credit card they want, whatever mortgage loan they want, whatever payday loan they want. We want them to be able to choose loans, to choose products, to choose services. We want the consumer to be empowered to do that. We want it to be done on a level playing field with high standards. So what they are choosing is based on transparency and honesty and integrity in the process.

Chairman DODD. Two final questions for you. I made the point in my opening statement that I thought if this were done well and right—as I plan to do so—that it is not only going to be beneficial to consumers, but the one argument we do not hear is that it is very beneficial to business, very beneficial to the financial institutions themselves to have a consumer protection agency, number one.

And, number two, a witness who will appear in the second panel, Mr. Wallison from the American Enterprise Institute, says in his statement here, "If we are looking for a primary cause of today's financial crisis, it is here," referring to the Community Reinvestment Act.

Why don't you respond to the issue of whether or not you believe the Community Reinvestment Act was the primary cause of the financial crisis as well?

Mr. BARR. Thank you, Mr. Chairman. Let me first say I agree with you that the Consumer Financial Protection Agency is good for banks as well as for consumers. If banks are competing on the basis of price and quality, that is good for them. If banks and credit unions and their communities can compete on a level playing field so we do not have a situation where a community bank wants to do the right thing but an independent mortgage company is stealing all market share with a policy that consumers cannot understand, we don't want that in the future. We want a level playing field based on fair competition, based on transparency to consumers.

With respect to the Community Reinvestment Act, I think the empirical evidence here, Mr. Chairman, is quite strong. I looked at this when I was researching at the University of Michigan. The Federal Reserve economists have looked at this question. The Federal Reserve found that about 6 percent of subprime mortgage loans were made by CRA-regulated institutions with respect to low-income communities or low-income borrowers. Six percent is unlikely to have driven, highly unlikely to have driven the subprime mortgage crisis.

If you look at the timing of our subprime mortgage crisis in the mid-2000's, it is hard to imagine that that was caused by changes in CRA regulations a decade earlier in 1995. If you look at the performance of CRA lending with respect to equivalent subprime loans, comparable performance levels. So I think the empirical evidence just does not support that claim.

Chairman DODD. They have very strong underwriting standards with CRA. The Community Reinvestment Act required very strong underwriting standards to be met by the borrowers. Is that true?

Mr. BARR. That is correct.

Chairman DODD. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Secretary Barr, the proposed Consumer Financial Protection Agency embodies the notions of behaviorally informed regulation that you wrote about in an article published in October of last year. The premise of that article, as I understood it, was that—and I will quote—"Individuals consistently make choices that they themselves agree diminish their own well-being in significant ways." That was in the article.

This dim view of the capabilities of the average American contrast with the author's belief, as we understood it, that bureaucrats are capable of discerning what financial products and services would maximize the well-being of individuals that they don't even know.

Why do you believe that bureaucrats working for a Consumer Financial Protection Agency would be able to make better decisions than American consumers themselves?

Mr. BARR. Thank you, Mr. Chairman. I appreciate the opportunity to make clear that that is not my view. In the first case——

Senator SHELBY. Was that in this article?

Mr. BARR. The quote is in the article, but the material that followed that you articulated was not in the article. So the material that followed is the point that I would say is not my view. I would say it in two particular respects.

One is I think the common human failing that we identified in the article are not about us versus them. They are common human failings that all of us have. All of us make mistakes in our daily lives. I get overdraft——

Senator SHELBY. We learn from those mistakes, don't we?

Mr. BARR. We do learn from those mistakes, and sometimes those mistakes are quite costly. But we all make them, is the only point I—I wasn't trying to say—I am not speaking for you, sir, but I know I make those mistakes all the time.

Senator SHELBY. I probably make more. Go ahead.

Mr. BARR. So just to be clear on that.

So these are mistakes that I make, at least, and that other people make and that are common mistakes, and our idea in the legislation is not to prevent people from making mistakes. It is to make it easier for them to avoid mistakes. Just easier for them to avoid mistakes.

So if you have a product that people cannot understand, then we need to figure out a way of making it easier for them to understand.

Senator SHELBY. I agree with that.

Mr. BARR. And, Mr. Shelby, I know you worked very hard on the credit card legislation to make sure that credit card products and services are offered in a transparent way, and to let people know the consequences of their financial decisions for the cost of making those choices, and that is exactly the kind of approach that is embodied in this legislation.

Senator SHELBY. Is your premise basically trying to take risk out of a marketplace? And if there is no risk, there is no marketplace, is there?

Mr. BARR. Sir, I think that risk and innovation are central to our financial system.

Senator SHELBY. We benefit from it, don't we?

Mr. BARR. We at times benefit from it and at times have costs from it, and on balance, financial innovation and risk taking are central to our system. What we are talking about here is not eliminating risk, certainly not eliminating financial innovation. Quite the contrary. I think those are central concepts. But we have to see that happen on a level playing field with high standards so that people are competing based on price and quality and not consumer confusion.

Senator SHELBY. The board of the consumer—the composition of the board, the proposal of the Consumer Financial Protection Agency would include the Director of the National Bank Supervisors and four members of the President's choosing. There is no limit on the number of members who are from the same political party. This contrasts, as you well know, with the limits on the composition of both the Securities and Exchange Commission and the Consumer Product Safety Commission.

Why did you choose such a politically biased construct at this point knowing that would raise red flags for some?

Mr. BARR. Senator Shelby, I would not describe it as politically biased in any way. In fact, it is designed to be not political, so there is not an identification of parties with respect to those matters. And the board——

Senator SHELBY. You do not say that, but that is what the result would be.

Mr. BARR. And if you look, for example, Mr. Shelby, at the Federal Reserve Board, we see a balanced range of individuals on the Federal Reserve Board without a particular requirement of party identification.

Senator SHELBY. I would like to just restate a request I made in my opening statement. I am sure the Administration used a great deal of detailed data—you know, you had to—and analysis that led to this proposal, because we would do this, too. Would you please provide that data and your analysis of that data to the Committee—not just to me, but the Chairman and all of us, staff on both sides—so that we can use it in our effort to evaluate your proposal? In other words, look at your data, evaluate it, weigh it, because we might agree with it. We might not. Would you do that?

Mr. BARR. We would be happy to work with the Committee to provide whatever information would be available and useful to you.

Senator SHELBY. You state, Mr. Secretary, repeatedly that the *status quo* is not acceptable because things are changing every day in the marketplace, as we know, and the need for a new independent consumer protection regime could not be clearer. In addition, you state that, "Banks can choose the least restrictive supervisor among several banking supervisors." Yet the Administration leaves in place in their overall proposal exactly that fragmented system for prudential supervision, four or five regulators.

Why is it that we must and why would you propose only one agency responsible for consumer protection, but four Federal banking agencies is entirely appropriate for safety and soundness regulation of our system? Why would you do that if you are going to

have the other? If we had one prudential banking regulator, you could draw the analogy, but I don't know how you do it here.

Mr. BARR. Thank you, Mr. Chairman. Our view was that in the context of prudential supervision and the arbitrage that we had seen on the prudential side, that we could effectively deal with that problem by merging the OCC and the OTS into a new national bank supervisor, and eliminating the thrift charter, eliminating the remaining distinctions between State member banks, State nonmember banks, and national banks, and requiring a series of protections against charter conversion in the event that there were pending enforcement matters, pending problems at any of the institutions.

It is not, I would agree, a perfect answer to that question, and in the context of the Consumer Financial Protection Agency, the problems that we saw were so pervasive, the basic structural problems so severe, the extent of mission conflict and mission confusion so strong, that we felt the only real answer there was a Consumer Financial Protection Agency.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, in a panel that will follow you, Mr. Yingling, who is the representative of the American Bankers Association, has a series of critiques, and I would like to go through some of them with you and see what your responses are.

First of all, he talks about how community banks are likely to have greatly increased fees to fund a system that falls disproportionately and unfairly on them, as they were not part of the present crisis.

Second, he talks about this agency having the power to compel the use of certain products that the agency would define.

Third, he talks about two lessons that he believes are fundamental building blocks of any reform of consumer protection oversight: One is that the uniform regulation and supervision of consumer protection performance should be applied to nonbanks as rigorously as it has been applied to the banking industry; and two, that regulatory policymakers for consumer protection should not be divorced from the responsibility for financial institution safety and soundness. And he talks about how the failure of nonbank regulation was the most severe under the current system.

So looking at those as some of the main points of critique of the legislation, how do you respond to those?

Mr. BARR. Thank you, Senator Menendez. I would be happy to address those four concerns.

First, with respect to community banks, community banks have endured a system under which they are forced to compete with independent mortgage companies and other unregulated lenders in the system. They have been forced essentially by market pressure to offer products and services that, if you are in their community and you talk to community bankers, they would rather not have offered. They would rather not have gotten engaged in pay option ARMs. But because or the unlevel playing field in supervision and regulation, the market tilted to bad practices, and market pressure

drove the market to a place that was bad for community banks and it was bad for consumers.

What we are saying here is there is going to be a level playing field for community banks, for big banks, for independent mortgage brokers, for anybody else in the marketplace. One regulator is going to set the standards, everybody can compete equally, on an equal footing.

Senator MENENDEZ. Are you saying that the proposed legislation that the Administration advocates is going to reach to those previously unregulated entities?

Mr. BARR. Absolutely, sir. One of the key features of this legislation is that nonbank providers for the first time are going to get subject to supervision and examination and enforcement with the same tools available to bank regulators. So the legislation would say the new Consumer Financial Protection Agency would apply these strong consumer standards across the board so that no one competes on the basis of an unlevel playing field or hiding the ball.

Second, with respect to the point about compelling the use of products, the agency here is offering a lighter touch form of regulation than banning or restricting products or services. What the legislation provides is if the agency sees a problem in the marketplace where some products and services are more confusing based on more difficult terms for consumers, instead of saying you can't offer that product at all—right?—which in some instances an agency would want to say, Oh, we want to ban that kind of product or service, in this instance the agency has a different tool, a more flexible and more nuanced tool. They can say, Look, if you want to offer a pay option ARM, you have to show a consumer first what a 30-year fixed-rate mortgage would look like or what a regular adjustable rate mortgage looks like, what a 5–1 ARM without hidden features or terms looks like, so they can compare and make their own judgment, make their own choice, but make it based on something that they can understand and that is comparable across the marketplace.

Third, with respect to nonbanks, let me just reiterate nonbanks will be subject to the same high standards, the same rules, the same supervision, the same examination, the same enforcement as banks for the first time ever.

And, last, with respect to the link to safety and soundness, again, I think we have had a system. We just experienced what it is like to have massive failure in a system in which bank supervisors do safety and soundness and also do consumer protection. And what happened is they did not do safety and soundness in a good way, and they did not do consumer protection in a good way. We had a massive failure in our system. And we need to reform it. We need to give them a single—the bank regulators need to have a single mission focused on safety and soundness, and we need a new consumer protection agency whose sole mission is consumer protection. Agencies can then have one job. They can be held accountable for doing that job. And you all can go out and talk to them and say, "This is your job. Why aren't you doing it?"

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and thanks for having this hearing. Mr. Secretary, thank you for your service.

I am going to digress just for 1 second. I think you may be the overall architect, if you will, of much of what has been put forth as it relates to regulatory changes, and I have been somewhat curious that the GSEs were not addressed, and if we could just spend about 30 seconds on that. Obviously, the largest liabilities that we as a country have, other than Medicare and Social Security, are within those GSEs, and yet at a time when you in essence own them, we are not in any way looking at changing their status or moving them along into a different direction. I am just wondering why you all chose not to address that.

Mr. BARR. Thank you, Senator Corker. In the Treasury Department's report, we highlighted the fundamental need that you articulated just now to reform those institutions, and we promised to come back to the Congress at the time of the President's budget submission in February with a reform proposal, and really our judgment was just about sequencing of what we could get done with you.

We think it is a high priority to get done. We will be proposing legislation to you with respect to reform of the Government-sponsored enterprises, looking at our mortgage finance system as a whole. And between now and then, we will be holding a series of public meetings as well as engaging in our own internal deliberations to focus exactly on that question. You are right. We need to address it.

Senator CORKER. When is "then"? When is "then," when you are going to be proposing this——

Mr. BARR. Oh, I am sorry. At the time of the President's budget submission, which is in February of the coming year.

Senator CORKER. So would you urge us to wait on regulatory reform until after that point so that we can address it all?

Mr. BARR. Our judgment, again, Senator Corker, I do not have—you all are obviously keepers of your own calendar, and I would not want to suggest anything with respect to that. Our own judgment in terms of the sequencing is that we could move forward expeditiously on the financial reforms measure we have put in place, that we have suggested that you put in place, and next turn to the Government-sponsored enterprises in February.

I do not think we can afford to wait for 6 or 7 months to do that. I think we need to act now and put in place these essential measures for the financial system.

Senator CORKER. So sort of a developing theme, I think, within the Administration, not necessarily with yourself, is that we have a lot of smart people who work with us that know better than the average citizen what ought to happen in so many areas, and it is just a theme that continues to evolve. So as I look at this agency—and I no doubt believe that consumer protection ought to take place. For the first time—and a lot of people have sort of compared this to consumer product safety, but, in essence, you all are advocating that you design products for the financial industry. That is a major departure from anything that has happened in any other category of the economy that I am aware of. But you guys would be designing products that all institutions had to conform to, which

is very different than product safety. They usually test products that are designed by others afterwards to see that they are safe.

I am just wondering, what is it that drives you all to that extreme?

Mr. BARR. Senator Corker, thank you for the opportunity to clarify again that that is not at all what we have in mind. So under this Consumer Financial Protection Agency, financial institutions can continue to offer any product or service that they want. The point of having a simple product offering is to say if you are going to offer a complex product like a pay option ARM, you also have to offer a straightforward product that exists in the marketplace—a 30-year fixed-rate mortgage with straightforward pricing and terms; a 5–1 or 7–1 ARM with straightforward pricing and terms.

So I think that if you look at the language that we have proposed, the factors that the agency is supposed to take into account, this is not designed to dictate all the products and services. It is not designed to——

Senator CORKER. But it does dictate some, right? Because you are dictating by virtue of what you just said.

Mr. BARR. It says certain products or services that are standard products and services, if you are going to offer exotic products and services, you also have to show the consumer what it would cost to take out a straightforward product that exists in the marketplace.

Senator CORKER. So if Senator Warner, who has been a tremendous entrepreneur, wanted to create a niche product to serve the public, he would not be able to offer that niche product unless he offered all of these other standard products, which if he were a new boutique kind of company that was trying to meet the need of a small part of our population that needed that service, he would be unable to do that under your legislation unless he offered all of these other types. Is that correct?

Mr. BARR. Senator, if you look at the areas in which this might apply, we are talking about, let's say, again, in the mortgage context, if an entrepreneur wanted to offer a pay option ARM, they would need to show the consumer what a 30-year fixed-rate or regular ARM would look like in terms of cost so the consumer can compare and make their own choices. They would still be able to offer these other products and services in whatever way they would like, but they would need to have a point of comparison that shows what the costs and risks are in relation to that standard.

Senator CORKER. I have a number of questions, and I guess we may have another round. I do not know if that is true or not. So what you are saying is this new entity under your proposal is not going to lay out basic requirements for certain types of products. You are not going to do that. Yes or no?

Mr. BARR. Senator, with respect to what a standard product is, you would be able to say a 30-year fixed-rate or a regular ARM is a standard product, and if you wanted to offer other products, that is fine; but you have got to compare it to this product, too. You would not be saying——

Senator CORKER. And you have to offer that product——

Mr. BARR. You have to offer the standard product if you are going to offer the exotic product.

Senator CORKER. OK. Well, I think my time is up, but I think what you have just said, again, is that smaller innovative companies that want to enter a market, which is what our country is about as it relates to innovation—that is why we are the leader that we are in the world. You are basically saying that these entities, unless they offer other standard products, would not be able to be in business. That is a large departure from where we have been as a country, and I want to revisit that with you. And I thank you for your service and your testimony.

Chairman DODD. Thank you, Senator, very much.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you for your testimony and for your presentation of this agency. It certainly has been a long time since we have had an agency that was dedicated to consumers in the financial world, and we have certainly seen many practices that have damaged the financial foundations of our working families. And so I certainly applaud the Administration for bringing this forward.

In your testimony and in follow-up questions, you talked about a level playing field. I wanted to ask about one aspect of that. If a State, for example, decided that it wanted to ban yield spread premiums or incentives to brokers to basically sell a more complicated product, a more expensive product, wanted to ban those or make them perhaps transparent, at least to be displayed to the consumer so the consumer understands where the broker is receiving their compensation, would they be able to do that under this legislation? And would it apply to all folks who offer or only for State-chartered institutions?

Mr. BARR. Thank you very much, Senator Merkley. So under our proposal, if a State wanted to have higher standards than exist under Federal law, they would be able to apply those standards. Under our proposal, the broad preemption provisions that had previously applied to national banks and their subsidiaries would not apply in that circumstance, so the higher standard would be available for institutions operating in that marketplace.

Senator MERKLEY. So this would eliminate the unfairness that has arisen in part in the past where State-chartered institutions might have been subject to higher standards imposed by the State, but had federally chartered competitors who were not subject to those standards?

Mr. BARR. That is correct.

Senator MERKLEY. Second, I wanted to ask you about a phrase, there is a set of tests in the law for what can be done, and to quote, "The agency must have a reasonable basis to conclude that the act or practices cause or are likely to cause substantial injury to consumers which is not reasonably avoidable by consumers, and such substantial injury is not outweighed by countervailing benefits." So we have a "substantial" test, a "not reasonably avoidable" test, and a "not outweighed by countervailing benefits."

Can you expand a little bit on those, and particularly this "not reasonably avoidable"? And let me give you an example. I have a constituent, an elderly constituent, who cashed in a check that came in the mail that was from an established financial institution that he did business with. He thought it was related to simply a

refund of an excess escrow fees or something of that nature. And, in fact, what it was in the fine print on the back was a high-interest loan—a very high-interest loan. And then the bank turned around and asked him to consolidate that loan with his other debt, and he ended up converting basically a very sound financial situation in short order into a situation that destroyed his equity in short order.

But one could argue that he could reasonably have avoided that by simply not depositing the check, that he could have read all of the fine print on the back of the check and made sure he understood it.

How does this test work in kind of the real world?

Mr. BARR. Thank you very much, Senator. The intent of the provision is to ensure that when the agency is thinking about the options available to it in regulating a particular product or service or sector, that it first try methods such as disclosure. So if we have a strong disclosure regime in place, could a consumer in that circumstance reasonably avoid the practice?

In the context, say, of credit cards, thinking back again to the work that the Senate did in getting that bill passed, the judgment was that double-cycle billing was not a practice that a consumer could reasonably—with disclosure could reasonably understand, and so the Senate decided that that practice was a practice that should be banned.

So the basic idea of this legislation is to say, let us try disclosure first. Let us see if there are ways to make disclosure work. Let us try and have robust disclosure. If disclosure can't work because the consumer can't reasonably shape his or her conduct to be responsible based on that disclosure because the information, the terms are so confusing that consumers can't get enough information to actually understand them, then it ought to think about other regulatory tools, and in doing that, it needs to consider the costs as well as the benefits.

Senator MERKLEY. So certainly a very clear set of reasonable tests to be met, moving from disclosure forward.

Mr. BARR. That is correct.

Chairman DODD. Thank you very much, Senator.

Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman and Secretary Barr.

I want to return to the issue that Senator Corker had raised with you just so that I understand it more clearly. As I understand the proposal, the new agency would, in fact, have authority and direction to create what are called plain-vanilla or basic products and services. Do I understand that to mean that in a number of different categories, the agency would decide what the basic vanilla product is, like the basic 30-year loan or the basic ARM and so forth?

Mr. BARR. The agency could decide to say a basket of loans is a standard basket of loans, so a 30-year fixed-rate loan and an ARM with straightforward pricing might be the standard loan or set of loans. And then consumers would have the opportunity to see what the costs of that loan were and compare it to the costs of, say, a pay option ARM.

Senator CRAPO. But conceivably, as we get more distinct and varied types of products, we could see more distinct and varied types of what we are calling plain-vanilla versions of those products and we could have a pretty long list or vast array of agency-established products, is that correct?

Mr. BARR. Senator, the intent and purpose of the provision is not, precisely not to have a proliferation of product-level decisions at a micro level but a basic set of standards that people can use as a point of comparison in making their decisions in choosing which product or service that they want. They will have a standard, a comparative point to look across the sector, as we did essentially with respect to the mortgage market until quite recently.

Senator CRAPO. I guess my point is, where does it end? Theoretically, the agency could just create one vanilla product, a 30-year loan, or a 15-year loan, or what have you, but it seems to me that what I am understanding you to be saying is that that is not what is contemplated and that there is, in fact, going to be an agency-established product for more than just a 30-year loan, but for other types of products and services that are going to be marketed. Am I correct there?

Mr. BARR. Senator, you can have the agency engage in this process in the mortgage sector. You might see it, say, in credit cards. I would think you would want to look at areas in which there is broad market participation, lots of consumers are involved, and there is a way of anchoring decision making in a comparable product. But I don't imagine it would be the primary tool of the new agency. It is an additional tool that it has, along with the other tools of disclosure and banning unfair and deceptive acts and practices.

Senator CRAPO. And am I correct that the proposal also contemplates that the consumer would be required to acknowledge in yet another notice or acknowledgment that they were offered these basic products as well as any other products that were offered?

Mr. BARR. Again, the agency has flexibility there, Senator. So it could, instead of—it could have a requirement that the consumer opt into an alternative product. It need not do it that way. There is flexibility built into the agency's structure so that it can choose that approach if it feels it is warranted under the circumstances.

Senator CRAPO. All right. Thank you. I would like to—because of time, I want to shift gears very quickly here to the issue of whether it is wise to separate safety and soundness regulation from consumer protection. I am sure you are aware that a number of authorities have indicated that there's a great danger in doing so.

I see a couple of problems. One, proliferation of regulatory agencies. I think we should be trying to consolidate and streamline our regulatory system rather than adding yet another regulatory layer. But also the fact that you could have inconsistent regulations between the safety and soundness regulators and the consumer protection regulators. And finally, the fact that the safety and soundness regulators or the prudential regulators will have access to information that could be very relevant to consumer protection and vice-versa. Why should we separate these two functions?

Mr. BARR. Thank you very much, Senator Crapo. I think that the key here is that in the past, we have had a system in which we

had a joining of the safety and soundness function and the consumer protection function in the banking sector and then no supervision or examination at all in the nonbanking sector and I think we have seen the results of that. We have had a system that hasn't protected consumers and hasn't been good for the safety and soundness of banks. It is very hard, I think, to say that our current structure with respect to consumer protection is good for consumers. It is very hard to say that it is good for banks.

I don't think we will see inconsistent approaches because the consumer regulator will have clear authority for the items that the consumer regulator has to do. The prudential supervisor has clear authority for what it has to do. And they each have to do their jobs.

And third, with respect to information, there is a requirement of information sharing between the prudential supervisor and the consumer agency. The examiners are going to share examination reports. The prudential supervisor sits on the board of the consumer agency. The consumer agency and the prudential supervisor both sit on the Financial Services Oversight Council. So I do believe there will be quite good coordination.

Senator CRAPO. Well, thank you. I have heard that explanation before, the fact that it didn't happen before, therefore, we should change. I am not sure that that really is a good reason to separate those two functions, but thank you very much anyway.

Chairman DODD. Thank you, Senator Crapo, very much.

Senator Tester.

Senator TESTER. Yes, thank you, Mr. Chairman. Thank you, Secretary Barr, for being here.

The proposal provides authority for the agency to collect annual fees or assessments. How do you see this impacting smaller financial institutions?

Mr. BARR. Thank you, Senator Tester. I believe that the new agency will be able to use existing fees that are collected for this purpose by the banking agencies——

Senator TESTER. OK.

Mr. BARR. ——and it will not increase the overall level of fees that are being collected in the system.

Senator TESTER. So they are going to be pulling some of the fees they are already paying to pay for the regulation that already exists?

Mr. BARR. That is correct.

Senator TESTER. So no increase in fees?

Mr. BARR. Well, under the legislation, there is broad authority for the agency. We don't anticipate that it would result in any increase in fees. It would likely result in a reduction in fees because the agency is consolidating functions across all the existing entities. There will be efficiencies of scale and scope in doing that.

Senator TESTER. All right. How do you see the States fitting into the Consumer Financial Protection Agency?

Mr. BARR. The States would have a quite important role. States have been at the forefront in many ways of consumer protection. States would be able to enforce Federal law. States would have a strong role with respect to their own examination and supervision processes.

Senator TESTER. Would they be able to go beyond the Federal?

Mr. BARR. And States would be able to set higher rules if they believe that the Federal standards weren't sufficient.

Senator TESTER. All right. There can be debate on why we have regulation. I can tell you, safety and soundness and consumer protection, I mean, if you don't have—it is all consumer protection in the end, as far as I am concerned. I think that is fundamentally, from my perspective, why regulation is set up. You may disagree. But in your statement, and it is in the written statement and you verbalized it again, you talked about how screwed up the current system is, and I agree and I think everybody in this Committee understands that it is severely flawed right now. And I appreciate the Administration coming forward with their proposal.

But the question is, does the proposal, this part of the proposal, other parts of the proposal, does it really fix the problem, because we do have a fragmented system and you can shop for regulators and all that stuff. Does it fix it?

Mr. BARR. In our judgment, sir, it does. I think it would prevent the kind of regulatory arbitrage that we saw in the past.

Senator TESTER. OK——

Mr. BARR. It sets high standards across the playing field that apply to everybody.

Senator TESTER. Correct me if I am wrong, but as far as consolidation of agencies so things don't fall through the cracks, the proposal is for the OCC and the OTS to be combined. Any others?

Mr. BARR. Yes, sir. I think if you look across the range of the proposals that we put in place, we would merge the OCC and the OTS into a new national bank supervisor.

Senator TESTER. Right.

Mr. BARR. We would prevent kind of shopping for regulators by firms that are in enforcement trouble. We would eliminate all the exceptions to the Bank Holding Company Act, the loopholes in the past that have permitted firms to escape consolidated supervised regulation at the Federal level. We would remove the Fed Light restrictions from the Gramm-Leach-Bliley Act so that the Federal Reserve can act as a consolidated supervisor. And each of those measures is designed to ensure that the kind of regulatory arbitrage we saw on the prudential side does not occur in the future.

Senator TESTER. OK. One of the things that has concerned me and I have expressed in this Committee many times is that community banks, credit unions, for the most part, have been pretty good actors in this whole thing. They haven't created the problem. And yet when it gets down to the nuts and bolts of regulation, they are being clamped as much as the Wall Street bankers that I think in a lot of cases should be doing time for what they have done.

So in this proposal, what can you tell me—Consumer Financial Protection Agency aside, what can you tell me that will make it so that this doesn't happen again or has a lot less possibility of happening again?

Mr. BARR. Senator Tester, we have a very strong proposal in our report and will soon be sending up legislation with respect to consolidated supervision of very large financial firms, what are called under our proposal Tier 1 financial holding companies. They will be subject to stringent supervision on a consolidated basis. They will have higher capital standards. They will have higher require-

ments with respect to liquidity. And the basic goal of that system is to create large cushions in the system so that when failures happen, if failures happen, there is a lot more give——

Senator TESTER. Are we doing the same thing to the community banks that you just talked about to the Wall Street banks?

Mr. BARR. The communities are not getting extra requirements——

Senator TESTER. Are we requiring higher capital standards? Are we doing some of the other stuff you talked about? What I am hearing that is happening on the ground because of what the bad actors did above them, if you want to call them above them, is they are getting pinched on capital standards across the board.

Mr. BARR. Sir, I think I want to separate, Senator Tester, what may be happening in the field with respect to examination today and what the proposals are for the future, and under our legislative proposal, we are focusing on raising capital in the system and raising it even more so and higher with respect to Tier 1 financial holding companies so that any incentive to be large is taken away.

Senator TESTER. All right. OK. Thank you very much. Thank you.

Chairman DODD. Thank you, Senator Tester.

Let me just comment here. I think Senator Tester has raised a good point. I think all of us would tell you up here, and I am sure you are aware of this, as well, that from our community bankers and, for the most part, the credit unions in our State acted very responsibly through all of this and what they worry about is being saddled with a lot of the cost that comes down. That will not be warmly received, I can tell you right now, just looking at it.

We need to make that case over and over again. There is a distinction in performance. We have a tendency to talk about banks in a generic context and don't draw the distinctions between those who acted responsibly and those who didn't. And so as we look at these proposals and ideas, we ought to keep that very much in mind. I can just guarantee you, there will be no willingness up here to levy kind of additional fees and costs on the community banking system of the country that is feeling a lot of pressure already.

Mr. BARR. Absolutely, Mr. Chairman.

Chairman DODD. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for your testimony. Let me start by simply saying I concur that there have been failures in the systems and that we need to figure out how to do a better job on consumer protection. I do have some questions about the approach the Administration is taking. I want to go back to some of the comments that Senator Corker and Senator Merkley made.

I am still struggling with kind of what the underlying theory here is. Is the underlying theory that the goal is enhanced disclosure in comparison, or as you raised, that there are times when disclosure in comparison may not be enough as was evidenced by the Fed's action on double-cycle billing? Take me through again what the basis is here. Are we going to look for some bright-line prohibitions or do we feel like a disclosure regime alone is enough?

Mr. BARR. Thank you, Senator Warner. I think that in the first instance, we need an independent, single-focused mission Consumer Financial Protection Agency. So the first principle would be clear mission, clear accountability, clear responsibility by one agency. That agency will have different tools that it needs to use in different market contexts. Some of those tools—the bulk of those tools will be disclosure. Disclosure can often solve many of the problems in our financial services marketplace, because if you clearly disclose a product or services, then consumers can choose the product or service they want. That is the best answer in many circumstances.

In some circumstances, you want that agency to do more. You want it, for example, to say to a consumer, not just here is the information about the transaction, but here is the consequence of this decision or that decision. So one of the things that this Committee and the Congress did in the credit card bill was say to credit card companies, you need to let consumers know how much it would cost them if they only paid the minimum on their credit card balance. That is an additional item beyond the traditional disclosure that in some contexts can make a big difference to consumers.

In other contexts, you need a standard point of comparison to make that disclosure meaningful, so not just the pay-option ARM costs X, but that is what it costs in relation to, say, a standard 30-year mortgage or in the kinds of pay-option ARM, a 5–1 ARM with straightforward terms. So points of comparison can matter a lot, too.

And then in the last instance, you have the ability to ban terms in products or services where they are unfair and deceptive and these other tools don't work.

Senator WARNER. But you would see this agency having that ability to ban certain products?

Mr. BARR. Again, as——

Senator WARNER. In a preclearance way or after the product has already been out in the marketplace?

Mr. BARR. There is no preclearance requirement under this legislation. It is not like other legislation the Committee may have considered in the past. There is no preclearance procedure with respect to all products and services. There is a requirement of disclosure.

Senator WARNER. But let us assume you have a product. It has been disclosed. You have got a comparison basis. In effect, the Federal agency has fostered that that is appropriate. But we are still allowing, then, the 50 independent Attorneys General to go out and raise the bar higher, correct?

Mr. BARR. Yes. So under the legislation, the traditional preemption by national banks would not be available and States could set higher rules for products and services. But with respect to the unfair acts and practices, the agency could step in and say, if you are offering a credit card with double-cycle billing, that is unfair. We can't disclose our way around it. So that particular term——

Senator WARNER. I guess what I just want to make sure I understand, you are saying that a product, that if the Federal agency had determined disclosure alone was enough, it then comes out into the marketplace and an Attorney General decides, no, disclo-

sure is not enough. We want to actually ban this product in State X. They can go ahead and initiate that action, and if it is successful at a State level, what does the financial institution—there is no kind of pass, that once you have passed the disclosure requirement at the Federal level, that you have got an ability then to go into the marketplace and offer this because you can still have the State Attorney General raise a separate action, is that correct?

Mr. BARR. No, sir. So the State Attorney General can only enforce State law that exists or Federal law that exists. If a State legislature decided to set a higher standard in a particular area, it would be free to do that as States are free in many areas of consumer life to set higher standards to that——

Senator WARNER. I know my time is up. Just one quick other comment. I am not sure I fully got your answer there, but I am interested in this area on the nonbank supervision, the question of going after financial products. Do you envision at some point the Administration coming forward on these noncurrently covered financial institutions? Are you going to look at their product mix underneath this legislation? Will you also envision at some point laying out some kind of safety and soundness oversight, prudential oversight, as well, for a series of nonbank financial institutions?

Mr. BARR. Senator Warner, this only applies to consumer financial protections. So in our proposal, consumer financial protection issues would be at this one agency and the consumer issues would be able to be examined across the financial services sector. But there is no proposal to have broad Federal prudential——

Senator WARNER. No prudential regulation on the whole nonbank sector of the——

Mr. BARR. Not with respect to, say, an independent mortgage company. Certainly with respect to, if you are a—within a bank holding company, the Federal Reserve would have consolidated supervision of all the entities within a bank holding company and it would be required to ensure that all the elements of the holding company are not undermining safety and soundness. So in that respect, yes, but not a broad new authority with respect to prudential supervision outside the bank holding company context.

Senator WARNER. Thank you, Mr. Chairman. I hope we get another round.

Chairman DODD. Thank you, Senator Warner.

Senator Johnson.

Senator JOHNSON. Mr. Barr, one of the objectives of the CFPA is to fill regulatory gaps, a goal I share. If a State does not examine a mortgage broker, would this agency? If a State does not examine a check casher, would this agency?

Mr. BARR. The agency, Senator Johnson, would have the authority to set uniform rules to examine and supervise mortgage brokers. It could also do that with respect to other financial services providers, including check cashers, with a goal again of having high standards across the financial services marketplace and a level playing field for competition, so banks and community banks and credit unions are not at a competitive disadvantage.

Senator JOHNSON. According to the draft bill submitted by the Administration, the CFPA would have the authority to oversee financial advisors who provide financial and other related advisory

services. Since the bill appears to exclude from the CFPA's jurisdiction all products and services regulated by the SEC, the CFTC, and State insurance departments, will you please clarify who this language is intended to impact.

Mr. BARR. Thank you, Senator. The basic language there is designed to deal with scams that have come up around the corners of the marketplace, where institutions that are not generally subject to any regulation offer what they call financial advice to consumers. It is primarily not aimed at State-regulated financial advisors, where there already is a system in place at the State level for regulating those institutions.

Senator JOHNSON. Could an unintended consequence of products be the consolidation of markets?

Mr. BARR. I think, Senator Johnson, that we will see lots of financial innovation in the future, lots of choice in the future in financial products. This agency will enable choice cross the financial services sector, enable financial innovation across the financial services sector based on a level playing field with high standards.

Senator JOHNSON. I can probably say that most mortgages are originated within the terms of 30-year fixed-rate mortgages. These products work for most of my constituents. That said, sometimes there are other products that are not plain vanilla that work for a consumer. Your proposal seems to create many hurdles for both banks that offer these types of products and consumers that use them. Do you think your proposal creates a disincentive for institutions to offer different products? Do you think that fewer products will reduce consumer choice? Could this indirectly increase the cost of credit?

Mr. BARR. Thank you, Senator. Our judgment is that the new agency will have the ability to set high standard across the financial services marketplace, including for mortgages, that we will continue to see innovation in the mortgage sector, but that if firms want to offer products that are difficult for consumers to understand, there will be a higher burden on them to explain those products and services. And I think that we have seen the consequences of a system in which there is inadequate supervision of those kinds of practices.

So I do think we are going to see a rebalancing, if you will, where it is a much lighter regulatory burden even than we have today with respect to straightforward products. So you can do things like combine the Truth in Lending Form and the Real Estate Settlement Practices Form into one simple Mortgage Disclosure Form everybody can use. That is easy under the new approach, very hard under the current approach. It is a way of reducing regulatory burden for banks, improving disclosure for consumers. We can see a lot of that happening in this space with the new agency.

Senator JOHNSON. My time is up.

Chairman DODD. Thank you very much, Senator.

Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman.

Thank you, Mr. Barr, for your service. I know you guys have a lot on your plate over at Treasury, so I am grateful for your time this morning and your focus on this important issue.

Can you outline for the Committee, what were some of the abuses that have been brought to light by the current crisis that this proposal intends to prevent?

Mr. BARR. Thank you, Senator Bayh. I think one key area where we saw abuse was in mortgage broker conduct. We saw brokers who were offered incentives to get consumers to take out loans that were more costly than the ones they qualified for——

Senator BAYH. And you forgive me for interrupting you. I agree with that wholeheartedly. That has been fairly well documented. How about in areas beyond mortgage lending?

Mr. BARR. I think, again, in the credit card context, this Committee has discussed problems with unfair practices in credit cards, problems we have seen with respect to bank overdraft fees, which are not disclosed as credit problems, problems in the payday lending sector, where there have been significant failings, problems in the auto loan sector, where disclosures have been inadequate and abuses have occurred. I think if you look really across the consumer financial services marketplace, at credit products, at payment products, and the like, bank products, there have been a series of failures of our existing regime to take account of the needs of consumers. And I am sure you hear the complaints from your constituents on these matters.

Senator BAYH. Certainly in the credit card area we did, and that is one of the reasons the Committee and the Congress acted in that area. So it is your judgment, Mr. Barr—and I agree with your assessment of many of the practices you have outlined there—it is your judgment that the problem can't be addressed by simply proscribing some of those things or tightening existing enforcement and regulation to prevent a recurrence or to require greater disclosure in the future?

Mr. BARR. That is our judgment, sir. I think if you look across the history of this matter, we don't want to fix one problem only to ignore and miss the next problem. We need an agency that is looking out for consumers all the time.

Senator BAYH. Let me ask you about the responsibility that consumers have, because an enlightened, vigilant consumer is really their best protection. It is hard to regulate against all these sorts of things. So what responsibilities do consumers bear under this regime?

Mr. BARR. I think consumers bear the responsibility to act responsibly based on the best information they have, and it is the job of the financial services industry to compete based on price and quality and not based on confusing consumers. But in our current system, the incentives to have hidden features are very large. We have seen that across the financial services marketplace. And so if you have an agency that can set rules of the road, everybody can compete based on transparent pricing and services. Consumers win. Financial services firms win. It is good for the economy. It is good for the country. So that is the kind of system we want to see going forward.

Senator BAYH. Several of my colleagues have touched upon the importance of disclosure, and you have touched upon the importance of prohibiting abusive practices. I think we all agree on that. But disclosure only works if consumers do their part, too, and that

is why I asked the question. We need to build in incentives for them to actually take advantage of the information that is being offered, process it, and then bear some responsibility for their own outcome, because if there is not some responsibility on the individual, the system is not going to work too well.

Mr. BARR. I think that is absolutely right. Consumers need to behave responsibly and we need to make the path available to them to do so.

Senator BAYH. Thank you, Mr. Barr.

Mr. BARR. Thank you.

Chairman DODD. Thank you very much, Senator.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman, and we appreciate your being here, Under Secretary Barr. Sorry I couldn't be here the whole time. We have the Judiciary hearings. That is why I am in the back here.

But I am very much for a Consumer Financial Protection Agency. In fact, Senator Durbin, Senator Kennedy, and I introduced legislation quite along the lines of this a while back and I am glad that the Chairman has made this an important hearing, an important part of our bill, and I am glad that the White House has supported it.

The bottom line is that the present regulatory structure has been an abject failure. I worked with the Fed on, for instance, credit card interest rates for 15 years. The progress was slow, it was muted, and way behind what the credit card issuers would come out with. And so to have an agency whose sole focus is on protecting consumers when the Fed has so many other responsibilities, and we are considering giving them even more responsibility, makes sense. Having the FTC do it, again, they are all across the board.

And look, let us face it, the kinds of deceptive practices that, for instance, occurred in the mortgage industry brought down the whole economy, and it is amazing to me that people say we don't need stronger regulation given that that has happened. It is just amazing.

And as for this idea, and I want to ask you about this, stifling innovation—some of the critics have said this—yes, it will. It will stifle innovation, clever ways to dupe the consumer, to sell people mortgages that they shouldn't have, to issue people more credit card debt than they can pay for. You bet, it is going to stifle that kind of innovation. But will it stifle a new product, as long as it is fully disclosed, that the consumer or mortgagor needs? No.

So please, we have had such a sorry history in the regulation of consumer financial products—sorry history, despite the efforts of you, Mr. Chairman, and others on this Committee on both sides of the aisle—that I would argue that if we don't include this in our financial regulation bill, there will be a gaping hole.

But I want to ask you the question about innovation, Mr. Barr. What about the argument that this new agency will stifle innovation of new products and things?

Mr. BARR. Senator Schumer, I think that the agency will enable financial innovation to occur based on a level playing field with high standards. It will prevent the kind of competition that we

have seen in the past based on—competition based on who can provide the most confusing terms and the most hidden fees.

Senator SCHUMER. Right.

Mr. BARR. But competition based on financial innovation for price and quality, transparency to consumers, that kind of financial innovation we will see more of, not less.

Senator SCHUMER. Right. Let me ask you this. What about the FTC? Some have said, well, the FTC can do these kinds of things. Has the FTC done at all a decent job in regulating financial products in the last decade?

Mr. BARR. Senator, I think that the FTC is a good agency with many good people in it. I think that it has not had the tools to do this kind of action. It is structurally not set up to supervise or examine the nonbank sector. It can only act long after the fact with enforcement when it is too late——

Senator SCHUMER. Right.

Mr. BARR. and that is just not enough. It can't act at all with respect to banks, and so we have a fractured system where everybody can point fingers and nobody gets the job done.

Senator SCHUMER. Right. And let me just ask one more question of you, and that is this. Right now, one of the things that hamstrung us was the fact that there were unregulated areas. In other words, if a bank issued a mortgage, there was some degree of regulation—I would say not enough, but some. But if a mortgage broker got from a nonbank financial institution financing, there was virtually no regulation at the Federal level, and when you talked to the Fed about it, which I did, they would say, well, we don't have jurisdiction. Isn't another reason to have this financial product regulator, which regulates the product and not the specific institution that issues the product, a way when the next new innovation comes up that there won't be a hole in the regulatory structure, because right now, we regulate by the type of institution, not the type of product issued?

Mr. BARR. Senator Schumer, that is exactly right. This institution, this new agency will have the authority to examine and supervise any financial institution. It won't be limited to banks. It won't be limited to nonbanks. It can supervise and examine and set rules across the financial services industry. So if you are a community bank and a credit union, you are not going to be put in a place of competing with an unregulated mortgage company ever again.

Senator SCHUMER. It will, as you say, create a level playing field across the board based on the product.

I thank you, Mr. Chairman.

Chairman DODD. Senator Schumer, thank you very much.

Senator Shelby has a comment he wants to make. I know Bob had a quick question. I am trying to get to the second panel if we can, as well, so I don't want to limit my colleagues here who want to raise another question or two here, but I do want to get to the second panel.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman. I will try to be fast. I do have a number of questions for the Secretary that I would like to be made part of the record.

Chairman DODD. And I have, as well, and I will submit those for the record.

Senator SHELBY. Mr. Secretary, you were one of the authors, and we have talked about this this morning, of the article that appeared, published by the New American Foundation, "Behaviorally Informed Financial Service Regulation," right?

Mr. BARR. Yes, sir.

Senator SHELBY. OK. Among other things in that article, I just want to quote from this, and this will be as quickly as I can say. It says, "We explore a different approach based on insights from behavioral economics on the one hand and an understanding of individual organization on the other. At the core of our analysis is the interaction between individual psychology and market competition. This is in contrast to the classic model, which relies on the interaction between rational choice and market competition. In the classic model, absent market failures, because rational agents choose well, firms compete to provide products and improve welfare. Because rational agents process information well, firms compete to provide information that improves decision quality.

"By contrast, in our model," and some of this is in this proposal, as I understand it, "individuals depart from neoclassical assumptions in important ways. The introduction of richer psychology complicates the impact of competition. Now firms compete based on how actual individuals will respond to products in the marketplace and actual competitive outcomes may not always and in all contexts closely align with the improved decisional choice and increase consumer welfare."

This is a real departure from, as you said in your paper, from the model that we have relied on for a long time. I am not saying that model is pure and perfect, because it is not, but this is a heck of a departure, is it not?

Mr. BARR. And, Senator Shelby, in that article, we are highlighting different models of thinking about human decision making——

Senator SHELBY. Sure.

Mr. BARR. and in most circumstances, competitive outcomes are going to lead to welfare enhancement. But in some circumstances where individuals are consistently prone to failure, it won't, and then the question is should the Government do something about that. Many times, the answer is no. It is sort of a trivial difference in outcomes. It would cost more to get engaged than it would to not get engaged and so you want the Government to do nothing.

In some contexts, though, the failures are so deep that you think some kind of step needs to happen, whether that is through disclosure or through providing information about the consequences of financial decision making, or in some particular circumstances saying a particular term should be banned, as this Committee did with respect to double-cycle billing.

Senator SHELBY. I understand, I think, where you are going, or trying to go. I hope you don't go too far here, or we don't. But on the other hand, an informed consumer—an informed consumer—that has relevant information will generally make a rational decision in the marketplace.

Mr. BARR. I think that is absolutely right. So I think that in most circumstances, most of the time, disclosure is going to get you most of the way there. And then the question is, in what context is that not enough? And again, as the Committee did with respect to credit cards, some practices you can't disclosure your way around. They are too complicated. Consumers can't—a responsible consumer trying to do the right thing couldn't actually figure out how to behave responsibly in that context.

Senator SHELBY. Wait a minute. But you are really saying that you don't trust the consumer to make decisions for themselves, in a sense.

Mr. BARR. No, I think consumers are—I trust consumers tremendously. What I don't trust is that if we set up the marketplace so that the incentives are to confuse consumers, that is the kind of competition we will get. We will get competition around confusing consumers. If we set up the marketplace so the rules are you compete to get consumers to your product because you have a better product, that is the marketplace we will get.

Senator SHELBY. But according to Senator Corker's question, as I understood it earlier, you are going to ration the products that you can offer.

Mr. BARR. No, sir. There would be no product rationing under this——

Senator SHELBY. You are not going to ration——

Mr. BARR. No product rationing under this approach at all. Consumer choice, individual freedom are at the heart of this. The key provisions of this Act would enhance the ability of consumers to make decisions that make sense for their own lives.

Senator SHELBY. Well, I hope we are going to have a lot of hearings on this, Mr. Chairman.

Chairman DODD. Yes. Jack, you have a question you would like to raise?

Senator REED. Thank you very much, Mr. Chairman, and thank you, Secretary Barr.

Can you walk through how the proposal establishes primary and secondary enforcement, rulemaking, and examination responsibilities?

Mr. BARR. Yes, Senator Reed. A core principle of our proposal is that supervision, examination, and rule writing should be joined together with respect to banks and nonbank institutions so there can be uniform rules of the road, real supervision and enforcement across the financial services sector.

We leave backstop authority at the bank agencies and at the FTC in case something falls through the cracks, in case something gets picked up in an exam and they need to refer it over to the new agency. But the idea is not to have any duplication, to have real core focus on consumer issues in one place with real responsibility and accountability to the Congress and the American people.

Senator REED. Can you comment about the alternative approach which some have suggested, which is essentially the bank regulators take the lead and then the CFPA would be sort of the backup?

Mr. BARR. Senator Reed, I think we have seen a system in the past where rule writing was at the Federal Reserve and super-

vision was spread around in the bank agencies and the system was fundamentally broken. The rule writer had a conflicting mission. The supervisory entities had conflicting missions. None of them thought consumer protection was at the top of what they would do. They would regulate banks based on reputation risk and litigation risk with respect to consumer issues, looking out for the interest of the bank and not consumers. I think we can't have that approach going forward.

Senator REED. Let me raise another issue and that is the funding. Your proposal, how would the CFPA be funded?

Mr. BARR. We look forward to working with the Congress on determining the right approach to funding issues. I know that is an area of great concern to the Congress. We need to ensure that the funding is stable and strong. Under our approach, there would be a mix of appropriated funds as well as the transfer of fees from the bank regulatory agencies with respect to consumer protection functions and fees in the area where such fees have not been collected in the past in the nonbanking sector. So we have a mix of appropriations and fees funding the agency. We would be happy to work with the Congress on that approach.

Senator REED. Mr. Secretary, a final question. There is at present the tension in the banking regulators between safety and soundness and consumer protection. Some would argue that consumer protection was always subservient to that, and that led—was one of the factors that led. How in this new approach do we balance the safety and soundness issue with the regulators who are responsible for it and the consumer protection issues?

Mr. BARR. Each agency would have responsibility for the mission assigned to it. The consumer protection agency would need to be sure that, say, disclosures are clear about a product or service, and the bank supervisory agency would have authority with respect to prudential supervision, underwriting standards, capital requirements, sort of core prudential supervisory matters. So a clear assignment of authority, clear assignment of responsibility and accountability to the Congress and to the American people for achieving those aims.

Senator REED. Thank you very much. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Bob, did you have a quick question on this?

Senator CORKER. Out of respect for everybody's time and knowing you want to move on, instead of asking questions, I will just make one statement. You have not alluded to student loans, auto loans. I know we have talked about mortgages. All of those are areas under your proposed legislation that you all would set up basic products. And while I said not necessarily on the front end, I just want to say, in listening to your testimony and answers, this is an example of all examples of this Administration being Big Brother, and I think the American people are recoiling from this. I think this is a tremendous overreach and very disturbing to listen to.

I hope that as you move along, we will be able to work together to do something that is not an overreach, where the Federal Government is telling citizens the types of products they should and shouldn't buy, and telling companies what they should and

shouldn't offer. This is way out of bounds and I look forward to working with you to get it in bounds.

Chairman DODD. Senator Warner, do you have a quick question?

Senator WARNER. I just want to make sure we try to get it right and I have still got a series of questions, but I will reserve those until another time.

Chairman DODD. I thank my colleagues. Let me just say, that is our intention, obviously, to get this right. I think your testimony has been very valuable this morning. Maybe Senator Schumer hit the note in a way. We don't want to forget what has happened over the last several years. It is unprecedented. You have got to go back to the generation of our grandparents to talk about a time similar to the ones we have been through. We have got 15 million homes underwater today—15 million—and every likelihood of those foreclosures continuing at a rate that is unprecedented, certainly in modern times, and the obvious implications of that are spread far beyond just home mortgages to other aspects of our economy.

And so the notion—when we lost sight of the—three great things done by the Depression Era Congress and Administrations were the establishment of the Securities and Exchange Commission, the establishment of the Federal Deposit Insurance Corporation, and Glass-Steagall, in my view. Those three things gave us virtually 60 years almost of unprecedented stability. When we began to wander away from having oversight of our financial institutions, we began to mix commerce and banking to the point where we thought we were going to have firewalls to protect people but did not do so, as well as not having adequate insurance under the Federal Deposit Insurance Corporation. We began to see the problems, and I can point to other aspects to all of this.

And so getting back to the notion that when that consumer—and the consumer, in my view, is the shareholder, it is the policy holder on an insurance policy, it is the borrower whether it is a mortgage or a car loan or a student loan—when we lose sight of that individual, if we don't take into view that individual's concerns and begin to look just top-down and not bottom-up, then you begin to lose sight of what this is all about to people. These are highly complicated areas.

Now, I think the issues raised about mandating or dictating or somehow driving certain product lines is something that we have got to be careful how we engage in that. Bob Corker has raised an interesting point and one that we ought to examine thoroughly. But the idea that we are going to have sort of disregard for what is going on, too often, in too many cases is where consumer issues have been lost in this process here.

The idea that when people walk in and they are being marketed—60 percent—according to the *Wall Street Journal,* 60 percent of the subprime mortgages went to people who otherwise qualified for a conventional mortgage, a lot cheaper product than that subprime mortgage. That is an outrage. That is people marketing products that they knew very well that that borrower could not afford, never at the fully indexed rate, and were going to be in trouble. And having a process which protects people against that kind of behavior, I think is critical.

Now, how we do this and shake this up obviously is a challenge to the Committee, working with the Administration and others. But my view is we have got to take this issue on and find a mechanism here that certainly fills that gap that has existed for far too long and created for the first time in 60 years the kind of break that occurred that we are all struggling with today.

So I appreciate your testimony. We will have additional questions for you to submit, but I want to get to the second panel here if we can, very quickly.

Senator SHELBY. Mr. Chairman, can I have one word?

Chairman DODD. One word.

Senator SHELBY. If I could, maybe one or two. We appreciate you coming here today, but even you admit in your studies, and this is an outgrowth of some of those studies, that this is a radical departure from the way we have regulated things before. We have tried to let the market work, let the consumer, an informed consumer, make decisions, not a bureaucrat make the decisions. And there are a lot of flaws in these proposals and that is why we are holding hearings, political and otherwise. But to move away fast and furious from a classical model of regulation, we had better be really careful. What we ultimately will do probably is really ration credit to people who need it the most.

Chairman DODD. Let me just say, and then we will give you a chance to quickly respond, we have been faced with a radical situation in our country. This is unprecedented. I respect that the classical model has fallen apart and the people who have paid the price for it are consumers. That home owner or that potential home owner, that person out there today who is losing their home, they are losing their jobs, they are losing their retirement, they are losing their health care, to them, this is pretty radical. This is not an abstract problem for them, it is a real one. And when you get 10,000 people a day losing their homes and 20,000 people a day losing their jobs, that is radical, believe me.

And so I am not looking for radical solutions here that don't meet the problem. But if we don't understand the depth of this problem, the anger of the people of this country of what they are going through and the demand that we start paying attention to what happens to them every single day they walk into an institution to borrow money, to buy a policy, to invest in a corporation because they want to increase their stability, then we are losing something here. So we need to get this right.

Do you have any comments you want to make quickly as we end up?

Mr. BARR. Thank you, Mr. Chairman. The Administration's proposal would represent a fundamental break from the past. I think it is clear that our system of financial regulation failed the American people and we need to have a new foundation, a firm foundation that protects consumers, and that is what this proposal does.

Thank you very much to you, Mr. Chairman, to Mr. Shelby, and to the Committee as a whole for hearing from me.

Chairman DODD. We will stay in touch. As Bob Corker said and others said, we want to work with you. We have got a lot of work to do, but we appreciate you being here.

Senator SHELBY. A lot of work.

Chairman DODD. Very good.

Mr. BARR. Thank you.

Chairman DODD. Let me go to our second panel, and we appreciate their patience, but I hope it has been worthwhile to be here with us. The introductions are going to be brief, so I don't have long introductions.

Let me first of all introduce my Attorney General. Dick Blumenthal is here with us. Richard has been our Attorney General for a long time and done a fabulous job, served in the Connecticut House of Representatives, the State Senate, a Sergeant in the U.S. Marine Corps Reserves, distinguished record, and I think the greatest Attorney General in the United States of America. I say that every time I get to introduce him. He does a great job.

Ed Yingling is an old friend and a person we respect immensely. Ed is the President and CEO of the American Bankers Association. All of us here have worked with Ed Yingling for many, many years and have a high regard for him and his abilities.

Travis Plunkett is the Legislative Director for the Consumer Federation of America and has appeared before this Committee on numerous occasions involving any number of issues, most recently on the credit card efforts, and I want to thank publicly Travis and the Consumer Federation of America for the tremendous job they did in promoting and advocating the legislative success we had with the credit card bill.

Peter Wallison, I have already drawn into the debate, having quoted from his testimony, but we thank you very much, Peter. I hope you didn't mind me mentioning your quote on CRA. Peter is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. I often quote Arthur Burns about the race to the bottom, he used to talk about, in regulatory processes.

And Mr. Sendhil Mullainathan is a Professor of Economics at Harvard University, and we thank you very much, Professor, for being with us.

Let me begin with the Attorney General and thank him for his testimony in advance and for your incredible career of public service to our State and the country.

STATEMENT OF RICHARD BLUMENTHAL, ATTORNEY GENERAL, STATE OF CONNECTICUT

Mr. BLUMENTHAL. Thank you, Senator. I am very, very honored by those kind words, especially from someone who has led consumer protection efforts in the country, most recently in the credit reform bill, and I want to thank you very sincerely for all that you have done in other areas of consumer protection and the leadership that you will no doubt provide the Committee in this area, which as you have said marks what seems to be a radical departure from past practices in a time that demands radical solutions.

It is a fundamental break with the past that is very well justified by recent history. This proposal would create a new agency, a very strong financial products watchdog and guardian, similar to the one that now exists at the Federal level in the Federal Trade Commission for other kinds of products, the Consumer Product Safety Commission for certain kinds of other goods and services, and es-

sentially would restore the historic State–Federal alliance that existed for so many years so productively in combating financial fraud and abuse.

This financial State partnership was riven and destroyed by excessive resort to Federal preemption, which displaced State enforcement and replaced that collegiality between Federal and State officials with conflict and tension that need not have existed. In fact, that conflict was one of the reasons why we saw the kinds of abuses that led to the financial meltdown.

That meltdown was foreseeable. Indeed, it was foreseen. I used the word "regulatory black hole" to characterize hedge funds and many of the other inventive and innovative financial instruments that very few people understood even as they used them, and the excessive risk taking, often with other people's money, that was enabled by that regulatory black hole.

And so I think that the genius of this proposal, or its great advantage, is to restore the alliance between consumer protectors at the Federal and State level.

The doctrine of Federal preemption has essentially led to the Federal Government abandoning the battlefield and then foreclosing the States from fighting on that battlefield. It has in so many areas prevented States, in fact, in many of those same areas that Secretary Barr answered to Senator Warner's question—payday loans, tax preparer anticipation refund loans, credit card issues, mortgage abuses—and I describe in my testimony—I am not going to read the testimony but just briefly say that in many of those areas where these abuses developed, our opponent was most frequently the Office of the Comptroller of the Currency.

I litigated more against the OCC than I did against any other single institution. And the most recent Supreme Court decision, *Cuomo v. Clearinghouse Association,* which restores some of our authority under the National Bank Act, was really against the OCC.

And so it isn't only that Federal authority has been fragmented, that the culture has been wanting, that the FTC has lacked the tools and resources, it is the hostility, the overt antagonism and adversarial posture of the Federal Government as against the States in consumer protection. And if it does nothing else—and it does a lot else—this proposal will help restore that alliance between State Attorneys General and the Federal Government.

I believe very strongly that this proposal is a good idea. There are details, as many Senators have already remarked, that need to be refined and perhaps changed. But in concept, the idea of having one central point accountable, fully accountable to those consumers out there who don't know where to call—and right now call my office—is a very, very important concept. The accountability to this body of the Consumer Financial Products Commission or Agency will be a tremendous advantage.

And let me just close by saying I couldn't agree more, based on 18 years as Attorney General, that consumers ultimately have to be their own protectors. But anybody who right now reads most of these documents, and I am trained to read them, will find them extraordinarily perplexing and confusing, not just in the fine print but in their concepts. And so this agency, as job number one, ought

to not only fill that regulatory black hole, but provide for clear, truthful, accurate disclosure, and that is one of the essential missions that has been completely absent.

I agree completely that the prudential responsibilities of the Fed and other existing agencies probably conflict, or at least create divided loyalties so far as consumer protection is concerned, another reason why we can't use either the FTC or the Federal Reserve to carry these important responsibilities, because consumer protection, especially in disclosure, is a mission that really requires, in financial products, a separate and distinct agency that has that accountability and will replace the current culture, the current mindset of conflict with the States and resistance to aggressive and vigorous consumer protection.

Thank you very much.

Chairman DODD. Thank you very much, General. Thank you very, very much.

Let me just also note that the Attorney General's son is with us today. We are delighted to have him in the room, by the way. We thank him for being with us.

Mr. BLUMENTHAL. Thank you.

Chairman DODD. Thank you.

Ed Yingling. Ed, thank you very much. You have been before this Committee on countless occasions over the years. We have a high regard and respect for you.

STATEMENT OF EDWARD L. YINGLING, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BANKERS ASSOCIATION

Mr. YINGLING. Thank you, Mr. Chairman. I appreciate your introduction. It may be my high-water mark this morning, but I really appreciate it. Thank you, Senator Shelby and Members of the Committee.

It would be expected that your Committee would look at this proposal from the point of view of consumers, who should be paramount in your consideration. However, the ABA believes that this proposal is not, unfortunately, the best approach for consumers and will actually undermine consumer choice, competition, and the availability of credit.

But I would also ask you to look at this issue from an additional point of view. While banks of all sizes would be negatively impacted, think of your local community banks and credit unions, for that matter. These banks never made one subprime loan, yet these community banks have found the Administration proposing a potentially massive new regulatory burden. While the shadow banking industry, which includes those most responsible for the crisis, is covered by the new agency, their regulatory and enforcement burden is, based on history, likely to be much less.

The proposed new agency will rely first on State enforcement, and yet we all know that the budgets for such State enforcement are completely inadequate to do the job. Therefore, innocent community banks will have greatly increased fees to fund a system that falls disproportionately and unfairly on them.

The agency would have vast and unprecedented authority to regulate in detail all bank consumer products. The agency is even instructed to create its own products and mandate that banks offer

them. And Senator Corker, this is the part that was missing from your discussion with the Secretary. The agency is urged to give the products it designs regulatory preference over the bank's own products. The agency is even encouraged to require a statement by the consumer acknowledging that the consumer was offered and turned down the Government's product first, and every nongovernment product would be subject to more regulation than the Government product. Community banks, whether it fits their business model or not, would be required to offer Government-designed products, which would be given preference over their own products.

On disclosure, the proposal goes beyond simplification, which is needed, to require that all bank communication with consumers be, quote, "reasonable." This is a term that is so vague that no banker and no lawyer would know what to do with it. But not to worry. The proposal offers to allow thousands of banks and thousands of nonbanks to preclear communications with the agency. So before a community bank runs an ad in the local newspaper or sends a customer a letter, it would need to preclear it with the new agency.

All this cost, regulation, conflicting requirements, and uncertainty would be placed on community banks that in no way contributed to the crisis.

The fundamental flaw in the proposal is that consumer regulation and safety and soundness regulation are two sides of the same coin. You cannot separate a business from its products. The simple example is check-hold periods. Customers would like the shortest possible hold, but this desire needs to be balanced with complex operational issues in check clearing and with the threat of fraud, which costs banks and ultimately consumers billions of dollars.

The breadth of this proposal is, in many respects, shocking. Every financial consumer law Congress has ever enacted and every existing regulation is rendered to a large degree moot, mere floors. No one will know for years what the new rules are and what they mean. When developing products and making loans, providers must rely on legal rules of the road, but now everything will be changed, subject to vast and vague powers of this new agency and anything States may want to add.

This problem is exacerbated by the use of new, untested terminology, again such as the requirement that disclosures be reasonable, whatever that means, which will take years to be defined in regulation and court decisions. If industry has no idea what the rules will be, what the terms will mean, and how broad legal liability will be, there is no doubt what will happen. Innovative products will be put on the shelf and credit will be less available.

We agree that improvements need to be made. The great majority of the problems occurred outside the highly regulated traditional banks, but there are legitimate issues relating to banks, as well. We want to work with Congress to address these concerns and implement improvements, and in that regard, my written testimony outlines concepts that should be considered.

I do want to put one fact back on the table that Secretary Barr referred to, and that is as we look at this and as we look at preemption, as we look at where the problems were, 94—this is the Administration's own numbers—94 percent of the high-cost mortgages occurred outside the traditional banking industry in areas

that are either unregulated, lightly regulated, or in theory supposed to be regulated at the State level.

Thank you, Mr. Chairman.

Senator REED [presiding]. Thank you, Mr. Yingling.

Mr. Plunkett, please.

STATEMENT OF TRAVIS B. PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Mr. Chairman, Ranking Member Shelby, Members of the Committee, it is good to be back with you. I am testifying today on behalf of the Consumer Federation of America and 23 consumer, community, civil rights, and labor organizations. We strongly support the Administration's proposal to create a Federal Consumer Protection Agency focused on credit, banking, and payment products because it targets the most significant underlying causes of the massive regulatory failures that have led to harm for millions of Americans.

First, agencies did not make protecting consumers from lending abuses a priority. In fact, they appeared to compete against each other to keep standards low and reduce oversight of financial institutions, ignoring many festering problems that grew worse over time. If they did act, and they often didn't, the process was cumbersome and time consuming. As a result, they did not stop abusive lending practices in many cases until it was too late. Finally, regulators were not truly independent of the influence of the financial institutions they regulated.

The extent and impact of these regulatory failures is breathtaking. I offer 10 pages of detail on 12 separate regulatory collapses in my testimony over the last decade that have harmed consumers and increased their financial vulnerability in the middle of a deep recession. This involves not just the well-known blunders that we have heard about on mortgage lending and credit card lending. I also offer lesser-known but quite damaging cases of regulatory inaction, such as the failure of regulators to stop banks from offering extremely high-cost overdraft loans without consumer consent, the permission that Internet payday lenders have gotten from regulators to exploit gaps in Federal law, and the fact that regulators have not stopped banks that impose unlawful freezes on accounts containing Social Security and other protected funds.

Meanwhile, the situation for consumers keeps getting worse as a result of these regulatory failures and the economic problems in our country. One in two consumers who get payday loans default within the first year. Mortgage defaults and credit card charge-offs are at record levels. Personal bankruptcies have increased sharply, up by one-third in the last year.

Combining safety and soundness supervision with its focus on bank profitability in the same institutions, regulatory institutions, as consumer protection magnified an ideological predisposition or antiregulatory bias by Federal officials that led to unwillingness to rein in abusive lending before it triggered the housing and economic crisis. But we now know that effective consumer protection leads to effective safety and soundness. Structural flaws in the Federal regulatory system compromised the independence of bank-

ing regulators and encouraged them to overlook, ignore, and minimize their mission to protect consumers.

The Administration's proposal would correct these structural flaws. Key facets of this proposal include streamlining the Federal bureaucracy by consolidating consumer protection rulemaking for seven different agencies in almost 20 statutes; providing the agency with authority to address unfair, abusive, and deceptive practices; ensuring that agency rules would be a floor and not a ceiling and that States could exceed and enforce these standards.

In response to this far-sighted proposal, the financial services industry has launched an elaborate defense of the *status quo* by minimizing the harm that the current disclosure-only regime has caused Americans, making the usual threats that improving consumer protection will increase costs and impede access to credit, and offering recommendations for reform that barely tinker with the existing failed regulatory regime. These critics are hoping that this Committee will overlook the fact that the deregulatory regime that they championed and largely controlled has allowed deceptive, unsustainable, and abusive loan products to flourish, which has helped cause an economic crisis and a credit crunch. In other words, the regulatory system that creditors helped create has not only led to direct financial harm for millions of vulnerable Americans, but it has reduced their access to and increased their costs on the credit they are offered.

Only a substantial restructuring of the regulatory apparatus through the creation of this kind of agency offers the possibility of meaningful improvement for consumers in the credit markets. The agency will be charged with spurring fair practices, transparency, and positive innovation in the credit markets, which should lead to a vibrant, competitive credit marketplace for many years to come. We strongly urge the Committee to support this proposal. Thank you.

Senator REED. Thank you, Mr. Plunkett.

Mr. Wallison, please.

STATEMENT OF PETER WALLISON, ARTHUR F. BURNS FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you, Mr. Chairman and Ranking Member Shelby, Members of the Committee. I must say candidly that I was shocked when I realized how this legislation will actually work.

For me, it raised the following questions. Are consumers protected when they cannot buy products and services that are available to others? Is that what consumers want? Does it matter what they want? These questions occur because the Administration's proposal for a Consumer Financial Protection Agency, the CFPA, results in the Government, I believe, essentially deciding which Americans will have access to certain financial products and which will not.

Traditionally, consumer protection in the United States has focused on disclosure. It has always been assumed that with adequate disclosure, all consumers at whatever level of education or sophistication could make rational purchase decisions. Consumer protection under these circumstances focused on fraud and decep-

tion and could take account of differences in consumer sophistication.

But the Administration's plan is based on an entirely different idea. That idea is that many consumers should not be allowed to have particular products or services because they are not sophisticated, educated, and perhaps intelligent enough to understand what they have been offered.

It is clear that in the Administration's plan, disclosure, no matter how complete, is not enough. The white paper that the Administration circulated before submitting its legislation contains the following language: "Even if disclosures are fully tested and all communications are properly balanced, product complexity itself can lead consumers to make costly errors."

As a result, under the proposed legislation, every provider of a financial service, and that term, incidentally, includes everything from banks to check cashing services, and from furniture rental companies to Western Union, every one of these institutions—not including, incidentally, securities firms or insurance companies, which are also involved in financial activity—is required to offer a plain-vanilla product or service to be defined and approved by the CFPA that will be simpler and entail, "lower risks" for consumers.

This raises, to me, the obvious question. Once the CFPA has prescribed a simpler and lower-risk mortgage, who will be eligible to buy the more complex product that is tailored to a consumer's particular needs? In effect, this question places on the provider the burden of deciding which of his customers is qualified for the more complex or riskier product.

Going beyond the plain-vanilla product will entail risks for the provider, who could face an enforcement proceeding and a fine from the CFPA, action by a State Attorney General or a State Consumer Protection Agency also to enforce the CFPA's regulations, and a class action by disgruntled consumers who claim they did not understand the risks associated with the nonplain-vanilla product.

As the white paper states, the CFPA should be authorized to use a variety of measures to help ensure that nonplain-vanilla mortgages were obtained only by consumers who understood the risks and could manage them. How would a provider determine whether a product with more features than the plain-vanilla product is suitable for a particular consumer? The white paper suggests that the CFPA could, "require providers to have applicants fill out financial experience questionnaires." This will be a humiliating experience for anyone, especially a consumer whose credit record up to that point has been completely unblemished. It is not a question of what he can afford, but what he can understand, a much more difficult question.

These elements are troubling enough, but this regime will be bad for all consumers. Product innovation will be stymied. Product variety will be diminished. Costs of credit will rise, and many small credit providers, small stores, finance companies, and others will have to leave the market. This will reduce competition and in some cases eliminate the only sources of credit for some consumers.

So those who will be able to get these more complex plain-vanilla products—more products than are plain vanilla—who are these people? Not ordinary Americans, in my view, whose lack of demon-

strable financial sophistication will make the risks of selling to them very difficult for most providers. The more complex products, the ones with useful features, will be offered only to the more sophisticated and the better educated, in other words, to the Nation's elites.

In this way and for the first time in our history, it will be Government policy to deny products and services to a large proportion of the population, not because the products and services are inherently dangerous, like drugs or explosives, but because this Administration apparently believes that no amount of disclosure can make some Americans capable of understanding what they are buying. Thank you.

Senator REED. Thank you, Mr. Wallison.

Professor.

STATEMENT OF SENDHIL MULLAINATHAN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. MULLAINATHAN. Mr. Chairman, Ranking Member Shelby, and Members of the Committee, thank you for providing me with an opportunity to testify.

As an academic, my comments will lay out some of the ideas and research behind consumer protection. By way of background, my area of expertise is behavioral economics. It combines economists' healthy respect for markets with psychologists' recognition that people are not financial engines churning out optimal decisions.

I will focus on making three points. First, the quality of choice is a result of the context in which we choose. Some contexts—many contexts allow people to choose well, but others do not.

Second, when people choose well, markets work very well. They provide healthy competition. But when people choose badly, they can race to the bottom.

Third, one tool in the proposed legislation, ring fencing so-called "standard products," provides a way to promote competition and prevent this race to the bottom.

So let me start with the psychology of choice. I am going to try and use two examples that are pretty familiar to all of you to illustrate decades of psychological research on how people actually choose. I want you to think back to the last time you painted a room in your house. You have thousands of colors to choose from. Benjamin Moore alone offers 140 shades of white. Yet, you sifted through this explosion of options and were probably happy with your final choice.

Contrast this with the last time you bought an electronic device, such as a digital camera. How do you choose between a smaller, cheaper 8-megapixel camera and a bigger, more expensive 12-megapixel camera? What is a megapixel? How many do you need? Are 12 megapixels 50 percent more than 8 megapixels? At the end of this process, you probably weren't really sure whether you bought the right camera.

The distinction here is that choosing between things you don't understand—megapixels is very different from choosing between things you do understand—color.

Part of choosing a mortgage is like picking a color. What monthly payment fits within your budget? Part of choosing a mortgage,

however, is like choosing a megapixel. How do you choose between a fixed-rate mortgage at $1,000 a month and one that begins at $900 a month but after 2 years changes to three points above the 1-year LIBOR? What does LIBOR mean? How much does it vary? Is three points above it reasonable? The provider says, "Hey, you can refinance this mortgage in 2 years." Should you worry about being able to get another loan in 2 years?

Note, this has nothing to do with elites or intellectuals. This is true for all people. These features of the difficulty of choice are the challenges of being human in choice context that are really not your area of expertise. The problem is not disclosure alone, it is about understanding. Sometimes disclosure produces understanding, but sometimes it does not.

Financial technicalities simply do not resonate with the concepts you use in everyday life. As a result, errors abound. For example, a recent study shows that 40 percent of borrowers with income less than $50,000 do not know the per period caps on their ARMs. It wouldn't surprise me if, like megapixels, they barely understood what a pro period cap is. Why should they?

Now let me turn to competition. As I pointed out, when people choose well, low road firms with short time horizons cannot do much harm. The best they can do is offer a product the consumer likes. In this case, markets work well and innovation helps consumers. However, when people are choosing badly, low road firms can confound both the consumer and high road firms.

Next to the $1,000 fixed-rate mortgage, the $900 balloon ARM has a superficial appeal. It is cheaper today. Nine-hundred is smaller than $1,000. Its risks down the road are harder to understand. The worse product can look like the better product. The high road firm can be pulled down by the low road option.

Now to my final point. I feel one powerful tool in the proposed legislation can be particularly useful in preventing the race to the bottom. Ring fence the standard, well-understood products and the more exotic ones. Regulate the standard ones minimally, ensure disclosure, prevent fraud, but regulate the more exotic ones stringently. The goal of this regulation should be to ensure that customers understand not just that the risks of these products be mechanically disclosed. Marketing can be endlessly inventive in sidestepping disclosure. The Consumer Financial Protection Agency needs stronger tools for products beyond the fence.

Ring fencing, though, is far more market friendly than a banner or mandate. It retains customers' ability to access exotic products. The CFPA would simply ensure that there is a door on the fence that requires conscious choice to go through. No one should unknowingly end up on the other side of the fence.

There are several precedents for this approach. I do not think this is the first time in American history this has happened. In fact, the SEC uses it as a way to regulate the trading of options and derivatives. If any of you would like to see this, try and buy an option. The Federal Reserve in July of 2008 placed some mortgages under far greater scrutiny. It is also analogous to how we regulate drugs. If you want to buy ibuprofen, you simply go and buy it. If you like a strong antibiotic, there are more barriers in place.

Ring fencing, however, requires a variety of things to work. First, there must be sufficient choice within the fence. This cannot be a one-size-fits-all solution. The goal of this is to maximize choice. It is not to create standard products designed by the Government. That would be a failure.

Second, there must be a clear, transparent process for how products enter the fence. This is necessary to encourage innovation. Lenders who create a good product must have the comfort that they can reap rewards from it. For this reason, it is important that the legislation should instruct the CFPA to develop and codify a transparent process by which products will be declared within the fence.

To summarize, real people choose badly when faced with technical features as financial choices sometimes require. To prevent a race to the bottom, financial regulation must prevent unfair competition from products with hard-to-understand risks. Ring financial provides one way to accomplish this goal. When effective, it provides a market-friendly alternative to bans and mandates. Thank you.

Senator REED. Thank you very much. Thank you, gentlemen, for your testimony.

Let me take 5 minutes and then recognize Senator Shelby.

General, thank you not only for your testimony, but for your service.

Mr. BLUMENTHAL. Thank you, Senator.

Senator REED. As a neighbor in Rhode Island, I am well aware of what you have done for your State and for the Nation.

Mr. Yingling suggested that we should put our attention on the nonbanking system, and yet your testimony suggests that there are real problems within the banking system because Federal regulators have essentially interfered with your ability to regulate what might be Connecticut chartered companies. Is that fair, and can you elaborate?

Mr. BLUMENTHAL. What has happened, Senator, and that question is a very good one, is that many nonbanking institutions have, in effect, invoked the shield by aligning themselves with national banks. In the gift card area, for example, we have been prevented from stopping expiration dates and dormancy fees on gift cards, from enforcing our State law, because they have used national banks. On payday loans or tax anticipation loans, again, the litigation is cited in my testimony. These institutions have, in effect, allied themselves with national banks to shield themselves from State authority. Again and again, what we have seen is that there has been a very knowing and purposeful resort to the national bank shield to protect these State and even local institutions because they have succeeded in invoking that Federal doctrine.

And so the proposal here to put a floor rather than ceiling on the impact of Federal regulation, I think is a very important one. It is hardly novel or new. It is essentially what is done in antitrust and other forms of consumer protection enforcement with the FTC and I think it would eliminate the incentive for these local institutions to, in effect, become part of or integrate their activities with the national banks.

Senator REED. Thank you, General.

Mr. Yingling, you have just laid out, I think, in your very good testimony, as always, the notion, and one that I think we all ascribe to, that safety and soundness and consumer protection are sort of two sides of one coin. And yet we have seen examples over the last several months where that doesn't seem to be the case. Maybe safety and soundness is not the word, but profitability seems to have come before consumer protection in credit card cases and many other instances, which leads, I think, to the thrust of what the Administration is proposing, that you have an agency that is, in fact, devoted not to this balance between safety and soundness and consumer protection, but has a focus on consumer protection. Your response?

Mr. YINGLING. Well, first, they are two sides of the same coin and I would just use the famous example now of the mortgage crisis, where that was in many ways a consumer issue, a terrible failure of regulation at both the Federal and State level with respect to regulating these toxic mortgages. At the same time, it is a tremendous safety and soundness question because it has blown up our economy to a large degree in a number of markets. Local banks that maybe never made a subprime loan in their life are being dragged down because the local economy is dragged down.

I think the main question we would have with respect to separation is just to use example after example where we feel that we are going to be caught in the middle. So take the account opening process. That is a combination. So we are going to have one examiner come in and say, in your account opening process, you need to change this disclosure. It needs to be clearer. You need to change this process. You need to change the way you are training your tellers. We spend billions of dollars training tellers on all kinds of compliance issues. The safety and soundness examiner comes in and says, I completely disagree with that. If you do it that way, you are going to encourage fraud, and by the way, you are not complying with the Bank Secrecy Act. What are we to do? All the legislation talks about is consulting, but ultimately, both sides have the power to say, you will do it our way. And there is just example after example. Check hold periods are another example where we would be caught in the middle.

Senator REED. Right now, could a Federal regulator make those same calls?

Mr. YINGLING. One Federal regulator could make the same calls.

Senator REED. And that Federal regulator, it seems, based on the record of the last several years, to make the call in favor of not consumer protection, but to the ability of the bank to continue to operate, reputational and other——

Mr. YINGLING. I would not argue with you, Senator, that there have not been failures and that things need to be done. But it is not always profitability. If you look at the check hold period, they have to balance what the consumers would like, which is the money right away, with the fact that we have a multibillion-dollar processing system that is evolving for checks with the fact that we are subject to billions of dollars in check fraud which is ultimately paid for by the consumers.

Senator REED. Mr. Plunkett, if you could comment on this discussion, I think it has been a good one.

Mr. PLUNKETT. The concern I have is that there are, until the last year, virtually no examples of the current safety and soundness structure putting consumer protection concerns first. The reason we need to go this route is because safety and soundness regulators, and we have to say this based on experience over the last 30 years, the norm for them is to consider the bottom line for the institutions that are regulated, and there is just example after example.

I mentioned in my statement overdraft loans, where the regulators appear to have dithered because primarily what is a deceptive practice, that is offering a loan without telling the consumer, charging the consumer fees without giving them a real right to choose to accept those fees, it is a very profitable line of business. So again and again, the norm for safety and soundness regulators has been to ignore consumer protection. It is all well and good to say, well, that should change, but I don't think that that is how safety and soundness regulators typically think.

Senator REED. Thank you very much.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Wallison, in your written testimony, you quote Justice Brandeis, who wrote, and I will quote, "The greater dangers to liberty lurk in insidious encroachment by men of zeal, well meaning but without understanding." Elaborate on that, if you would, because as I raised earlier the question to Secretary Barr, this is a radical approach, different from our classical approach to regulation, is it not?

Mr. WALLISON. Yes, I think this is a very paternalistic approach and quite different from anything we have had in the past. In the past, we have always used disclosure, and disclosure can be improved. There is no question——

Senator SHELBY. Absolutely, it can.

Mr. WALLISON. Actually, my AEI colleague, Alex Pollock, has come up with a one-page disclosure form for a mortgage which you would have to look at before you signed up for the mortgage—not at the closing, but when you sign up for the mortgage—and that would list all of the various risks and so forth and the costs of the kind of mortgage that you are taking. That is an improvement——

Senator SHELBY. In plain English, right?

Mr. WALLISON. In plain English, that is exactly right. People can understand that. Instead, what we are proposing to do here is really to say to providers, you are going to take the risk of offering something more than this plain-vanilla product. If you take this risk and it turns out that the consumer is not pleased with it or we, the regulatory agency, are not pleased with it, you are going to have to pay some very substantial costs in the form of enforcement. This is a completely different way of looking at consumer protection and radical in my view, too.

Senator SHELBY. Could this in a big way ration credit to some people who need it the most?

Mr. WALLISON. Well, exactly. The effect of this, of course, is when a provider is confronted with the choice of whether to offer only the plain-vanilla product or the more complex product, he has to decide whether this particular consumer is going to be able to understand

the product. And as I quoted in my testimony, the white paper says here that disclosure itself may not be enough. For some people, complexity itself is going to make it difficult for them to sign up for something that they may not understand.

So the provider has to make this decision, and what the provider is mostly going to do is say, I am sticking with the plain-vanilla product because if I go any further with that, with this particular consumer, I could get in trouble, and that will reduce the products that are available to consumers, I am afraid.

Senator SHELBY. Financial institutions, as I understand the proposal, will no longer be primarily concerned with discerning and meeting the needs of their customers. Instead, they would be concerned with gaining regulatory approval and avoiding taking any steps that would lead to enforcement actions or, obviously, costly litigation down the road. Do you agree with that?

Mr. WALLISON. Yes, of course. That is the thing that I think the people in the Administration missed—that there is a very important problem for providers, a very difficult problem in fending off litigation and enforcement activities. They want to comply with the law, and so they have to know exactly what it is that they can do. If they are left in a position where they have to make a decision about the ability of someone sitting in front of them across the desk to understand something, well, there is only one decision they can make and that is to limit what they offer.

Senator SHELBY. Mr. Yingling, the proposal states that the agency would have to, quote, "consider the potential benefits and cost to consumers and covered persons." Consider and potential are not very definite words, I would think. Shouldn't the language require that the real benefits must outweigh real costs to consumers and covered persons instead of that? The agency could not meet its mandate, as I understand it, to promote efficient markets if in the end the transaction is not beneficial for both parties in the transaction. That is the way the market works, does it not?

Mr. YINGLING. Senator, that is basically the only general standard in it. The authority of this agency is broader than any agency, I would say, that has ever been proposed. If I could, let me just read you the one section. This is Section 1037(1)(a). In general, the agency shall prescribe rules imposing duties on a covered person. Now, a covered person is anyone that offers consumer financial services. So the agency shall prescribe rules imposing duties on a covered person as the agency deems appropriate or necessary to ensure fair dealing with consumers. That is it.

Every single law you have ever passed, every regulation on the books is trumped by this. They are just floors. And the standard you cited, I could go in the hall with a couple of lawyers and in an hour come back with a paragraph, a boilerplate paragraph with a couple of blanks in it that this agency could put in every rule they write to meet that standard.

This agency is empowered to do anything it wants, and I don't know what that means your function is, because that credit card bill you just worked so hard on is now nothing but a floor, trumped by this section.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Shelby.

Senator Warner, please.

Senator WARNER. Thank you, Mr. Chairman.

I share some concerns about some of the Administration's proposals, but I want to go back with Mr. Wallison. I am not sure that I would concur that the sense that the Government is going in certain cases to prohibit certain products as being too dangerous, that that has not been due course of doing business. I mean, we have done it recently. The Fed has done it recently with double-cycle billing in the credit card area. We have had longtime prohibitions against loan sharking. I used to be in a pretty good business in the venture capital business, but we had, as we have discussed, Peter, prescriptions that said not everybody can invest in venture capital fund. You have to be a qualified investor.

And I understand the notional difference between investing and access to credit, although I would argue that some of the products that we have created have been all about marginally lowering the cost of risk, and there is some judgment of marginally lowering the cost of risk versus the overall societal downside risk we are taking. There has got to be some balancing here.

So I know where you are going to come back at me on this, but I do want you to come back at me in terms of saying, would you say market all the time, no prohibitions at all on any product mix, disclosure alone always trumps?

Mr. WALLISON. No. Thank you for the question, Senator, but that would not be my view. I think there are things that one could—the Senate could, the Congress could—forbid, and should, because some things can actually be abusive. But in general, what we are doing with this legislation is putting providers in a position where they have to make a judgment about the ability of the person sitting across the desk from them to understand all of the factors that go into a particular product that is being offered.

And so what we are saying in this legislation essentially is, here is the plain-vanilla product. If you offer this product, you are not going to take many risks because it has been approved by the CFPA and here are the disclosures that the CFPA wants you to make about it. And the provider puts that product in front of the customer and says, "I think you should take this product" because the provider has made a judgment that this customer probably can't understand or might not be willing to understand the complexities of the other products that the provider could offer to customers who are more sophisticated and experienced.

So the result of that, I think, is going to be only one thing, that many, many people who could understand, with adequate disclosure, products that are going to be better for them and their families will never have those products offered to them.

Senator WARNER. But in this example, I mean, in the normal marketplace, if we put out a symbol that says "buyer beware," buyer makes the wrong choice and the market absorbs the consequences. But in this circumstance, at least we have seen in recent action there perhaps was not a "buyer beware" on some of these exotic financial mortgage products. I have got members of my family that I argued diligently against, don't take that product. You are going to get it. But they saw the up-front sticker price and they bought it anyway. Not everybody has got a wealthy brother

to bail them out, although I guess we do have a wealthy Uncle Sam that is now indirectly bailing out.

But if at the end of the day the ramifications of buyers making bad choices around the credit markets is that we, the taxpayers, are ultimately going to bail them out, don't we have some responsibility to perhaps put some either ring fencing or some parameters around this? I mean, are we in a different mix of products when we are at the end of the day maybe having the taxpayer be on the hook for bad choices made by consumers? Is there——

Mr. PLUNKETT. Senator, buyer beware doesn't always work. As you pointed out, it is not just the new credit card law. In 2005, Congress said payday loans and other high-cost loans are not good for our service members and prohibited them. There is actually a long line of recent Congressional and regulatory measures that have acknowledged that the disclosure-only approach doesn't work. Telling somebody that you are going to deceive them and then deceiving them is not a good thing. So we need to recognize the limits of this disclosure-only approach.

Mr. WALLISON. This makes my case, I think, and that is there is no way that a provider can offer a product that he is not certain the person sitting across from him understands.

Mr. YINGLING. I think——

Mr. PLUNKETT. But that occurs all the time in the securities world. Suitability is embedded in the new legislation that the House has passed on mortgage lending. It is absolutely possible to make those determinations and it is done in law.

Mr. YINGLING. Some products should be banned. Some products should have a "buyer beware" sign on them, and that is what the Fed has done, in effect, with their new mortgage regulations. If you cross a certain line, it has a "buyer beware" sign on it.

What this proposal says is if you deviate in any fashion from the plain-vanilla product, so I will use a different example. I will use basic banking accounts, because that will be part of this. So they design a basic banking account and if the community bank in Nashville says, I have a great idea that the students at Vanderbilt will love. I will add an Internet feature. If Navy Federal Credit Union says, I have a great feature I can add that will be good for sailors at sea, they are no longer part of the plain-vanilla product.

Let me read you what this says. This is the thing that was handed out at the White House, the report that went with this legislation. For example, the CFPA could impose a strong warning label on all alternative products, require providers to have applicants fill out a financial experience questionnaire, or require providers to obtain the applicants' written opt-in to such products. Originators, talking about loans, of alternative products should be subject to significantly higher penalties for violations.

Why would that bank in Nashville, why would Navy Federal Credit Union offer these changes to the basic vanilla product? It is one thing to have warning labels. It is one thing to outlaw products. It is another thing to say, if you don't offer our product, you are subject to all kinds of new regulatory restrictions. I am quoting them. This is their proposal.

Mr. BLUMENTHAL. If I may try to bring together these two points of view from the standpoint of——

Senator WARNER. Let the record show, Mr. Chairman, that I am not extending my time. The panel is.

[Laughter.]

Senator REED. This is the General and it is the General's preference, so go ahead.

Mr. BLUMENTHAL. The highest I made it in the Marine Corps Reserve was Sergeant, so——

Senator REED. I am actually in a higher rank.

[Laughter.]

Mr. BLUMENTHAL. If I can bring together these somewhat differing abstract points of view from the standpoint of the cop on the beat, and we are talking here about an enforcement authority as much as a regulator, we may disagree on what should be banned. I think there is some agreement that certain products should be banned. We can disagree on where the floor in enforcement should be.

But the question really for this Committee and for the Congress is, should we have a point person, an authority that is accountable for protecting consumers, whether they have a wealthy relative or not, and assuring disclosure, uniform disclosure nationwide in an age where—and this is one of our great frustrations—the mortgage rescue scams, the tax anticipation loans that charge 300 percent interest can disappear into the Internet ether and we need Federal enforcement. Otherwise, even with the best and most vigorous State law enforcers, including Attorneys General, that system will be ineffective.

And so I think it is more than which products should be banned, and certainly some of these standards need to be tightened. I accept very wholeheartedly Mr. Yingling's critique of this first draft of the legislation. There need to be stronger standards, perhaps. But do we need an authority that will ally with the States in providing stronger enforcement? My answer is yes.

Senator WARNER. You wouldn't end up being where you have got just the floor set at the Federal level. Could a financial institution ever have felt like they have finally passed muster and they aren't going to be then still subject to 50 additional Attorneys General trying to come after their product, even if they have passed muster at the Federal level?

Mr. BLUMENTHAL. And I think one of the challenges, Senator, and I will be very brief in my response, but I think you have identified, as you did earlier in your questions, one of the key questions, which is how to harmonize Federal and State enforcement. But that is a tension inherent in our Federal system. We go through it in the criminal system with many other areas except where there is total Federal preemption, as in the food and drug area. But if we are going to have State enforcement, there needs to be harmonization. I think the SAFE Act recognizes the potentials for harmonization. So do the recent credit card reforms. I think we are moving in the direction that keeps alive the Federal system, and I think they can be harmonized.

Mr. PLUNKETT. Senator, I would just add that if the minimum is high enough, then you will achieve uniformity because most States won't see the need to exceed that minimum.

Senator REED. Thank you.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and I thank each of you as witnesses. It is always highly beneficial to us to have people like you here and I thank you for that.

Mr. Wallison, I do want to thank you for your comments. I agree with almost everything you have said, and we have met many times. I appreciate certainly your testimony today.

Professor, I listened to the pixels and the ring fences and very much appreciated what you had to say, also. I still was unclear, though, as to whether you viewed disclosure—you were talking about the psychology of people purchasing things in an economy—whether you believe that disclosure is enough or whether you believe, like this Administration, that they are wise men that govern ignorant souls that need to be directed as to what to buy and not buy. I still was unclear and I would love some edification there.

Mr. MULLAINATHAN. Thank you very much. I think it is useful to set two extremes. I think by focusing on contrasts with disclosure, we are failing to recognize that sometimes in this sector we also engage in bans. We have done that with the credit card bill and it will happen again.

So to me, the challenge is not about disclosure and moving to do more than disclosure. The challenge is when we are setting up an agency, are we going to handicap it by giving it only two extreme options, disclose or ban. To me, that is unfortunate. That is exactly a bad market solution because there are products which have benefits for some consumers but which are complicated for other consumers. As a result, disclosure might not work. It may be hard to get some consumers to understand fully the most exotic products, but we don't want to ban them because they have genuine benefits for a variety of other consumers.

I think that raises a—there is a set of products that fall in that middle, and to me, ring fencing and the proposals in the legislation—and I have to admit, maybe I am reading a different draft. I don't see Government design or Government standards in this draft. To me, what this does is it gives the opportunity, and I think more clarity is needed in the bill and I think moving forward that is where we would need clarity, but it gives an opportunity to say, let us recognize the financial services require some middle ground. Sometimes, we will want to keep exotic products in the mix. Therefore, we won't want to ban them. But we will need something more than disclosure, because a lot of consumers, as with double-cycle billing, there is no single form that is going to simply explain to consumers the most exotic products.

And even if there were a single form, the reality of the way you buy something is such that someone can give you that single form and eight other pieces of paper on top of that single form. I have rented cars many times, and I realized the other day, they say, put an X here, an X here, an X here, put your initials there, and sign here. I don't know what I am signing for when I sign those things. I have never read the disclosure on that form. Maybe some of you have.

But the point I am trying to make is that marketing is very powerful. Disclosure for many customers for exotic products won't necessarily work, but at the same time, I wouldn't want to resort to

a ban every time we encounter that situation. And I think it is that middle ground that is trying to be attained by this bill. Though, I understand the risks if that middle ground is not done well, and I would think the challenge of working and crafting this bill is to give the agency another tool beyond either of these extremes.

Mr. YINGLING. I will just say Section 1036 of the bill, Standard Consumer Financial Products or Services, clearly authorizes them to mandate products and to put restrictions on products that are not mandated.

Senator CORKER. Which brings me——

Mr. PLUNKETT. The idea is not to have a bureaucrat designing a product, Ed. The idea is to, as we heard from the Administration, make sure that as a class there are alternatives.

Mr. YINGLING. I can only deal with what the statute says and what their proposal——

Senator CORKER. I would like to interject here, if I could.

Mr. YINGLING. Sorry, Senator.

Senator CORKER. Thank you both for your vigorous help in this.

So, Mr. Yingling, you have been before us before, and obviously because of the group that you represent, people are going to say that when you say that we can do this within the confines that we now have, you are basically arguing for the *status quo.* I know that is not what you are arguing for. But if you would, tell us how within the present regulatory system that we have we can ensure that there is consumer protection. And, second, what kind of products do you think would go away under this type of regime? Good products, by the way.

Mr. YINGLING. Well, first we are not arguing for *status quo.* The *status quo* has been a failure, and so we are arguing for change.

One thing I would point out is there has been a significant change in terms of the power of the agencies using UDAP. And if you look at the credit card regulation—which you all trumped with a stronger bill, but a lot of it was in that regulation—this is a new era. The use of UDAP by the regulatory agencies is much stronger, and we would recommend that a bill that was passed by the House last year which grants that authority in a coordinated fashion to all the regulatory agencies should be adopted.

You are going to deal with a systemic oversight regulatory that is controversial, but that systemic oversight regulator should have the authority to look at these consumer issues in a coordinated fashion.

One of the great obvious failures is why our Government did not see—did see, to a large extent, but was not really charged with saying look at the graphs in the growth of these kinds of loans, let us investigate it, let us stop it. The systemic regulator should be given that charge.

There should be a coordinated place in the Federal Government where consumers can call in. You raised that point. It is a very legitimate point. They do not know where to call. There should be a coordinated place where they can call, and then the statistics are kept, and that is referred for action to the correct regulator.

There should be greater coordination at the Federal level with the States. I think we have gotten into the habit of having these court fights, and in reality we should be sitting down at the table

between the States and the Federal regulators and figuring out how to do it. There are a number of things that could be done.

In terms of products that would be innovative, every single day in this country in some bank they are thinking of how to adjust a mortgage product, adjust an automobile loan, adjust a basic banking account. They are sitting around a table saying, "Oh, if we could add this Internet feature, if we could add a feature for senior citizens." They are constantly adjusting. And some of those fail; some of those helped in their market; some of them become great products that others start to offer. And I can only deal with the language that they have offered. All those are not plain-vanilla products. Any time you deviated, you would not be a plain-vanilla product. And so if that is not going to chill innovation, I do not know what is, because you are subject to all kinds of extra rules if you cannot make those deviations.

Senator CORKER. Mr. Chairman, thank you, and, gentlemen, I want to say that the comments you have made indicate to me that while you want to see strong consumer protection, because that is what you do, and you see abuses, that you, too, even see this bill in its present form as an overreach and that we have a lot of work to do to get it right.

Mr. BLUMENTHAL. I would agree with everything you have just said except perhaps with the term "overreach." And I do not mean to quibble or criticize. I agree with you wholeheartedly that this bill is a first draft; it needs refinement, it needs work. And I think with your help, with Senator Shelby's, and with all the Senators who are here, particularly Senator Dodd, we are going to reach the goal line. But I do think that a point of accountability somewhere that your constituents can call when they have a question or a problem and they need an enforcer to protect them against a usurious interest rate or any of the abuses we have been talking about here I think is tremendously important.

Thank you.

Senator REED. Thank you.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony.

Mr. Yingling, I appreciate many of the comments you made. I know you spent a lot of time in your testimony talking about community banks, and I am concerned about the pressures we are putting on them. But it was not just community banks. If it was just community banks, we would not be in trouble. You know, we have Bank of America, we have given it a lot of money; Citi, we have given it a lot of money. So while I understand your focus on community banks, the reality is that we have a range of banks here, some which clearly acted in ways that were not, I guess, in their interest and certainly not in our collective interest because they created systemic risk, and that is why we are giving them enormous amounts of money.

And while I think you have some legitimate concerns in your testimony, I am concerned, as I have said in the past to the association on other matters, is that, you know, I read the elements of what you have listed here as improvements that can be made. And, you know, my concern is that if the industry does not get out there

and be for significant changes, then it will face a legislative action that it probably will not like at the end of the day.

And so I hope that when you say that we are not for the *status quo* and we are for change—but I read the changes and, you know, centralized call centers and, you know, basically saying that we should enable basic products, you know, when even in your testimony you recognize some of those problems become overly complex and difficult, as well as that they often have consumers buying products or enhancements that are not right for them, for which they pay too much, you know, is not in my mind the type of reform we are going to need. I appreciate what you talked about on OTS. That is, I think, a good offer, but after that it seems very little to me.

So I would urge, you know, the association to be more aggressive in what they are offering here in terms of a legislative response. And I am concerned, you know, that—I look at where we are at, and it seems to me that a lot of, prior to the crisis, financial institutions changed their charters to shop for lenient regulators. And it seems to me that by imposing uniform regulations on consumers financial products across all types of financial institutions, one of your concerns, but listening to the Secretary pretty much sound to me like we are talking about all types of financial institutions no matter who regulates them, wouldn't the Consumer Financial Protection Agency reduce the incentives to shop for more lenient regulators, at least with respect to consumer product legislation?

So I think that while we can tailor this a little better, the reality is that we need this. So, you know, I am—I hope the industry will be a little bit more forthcoming in terms of real change so that we can strike the right balance at the end of the day between having the financial products we all want to see open to consumers but having the protections that are critical at the end of the day. And it is in that spirit that, you know, I certainly come to this with, and I hope others do as well.

I just get, you know, a sense—you know, Mr. Plunkett, when most Americans go apply for one of the hundreds of different kinds of mortgages, they do not typically bring a financial adviser along with them, do they?

Mr. PLUNKETT. No.

Senator MENENDEZ. And when a mortgage broker or lender talks to somebody about a 5–1 interest-only ARM or a negative amortization loan, how many people do you think really understand that?

Mr. PLUNKETT. I wouldn't—Senator, you make some very good points here. What we have heard so far from the financial services industry in terms of their "reforms," I heard a systemic regulator maybe, but I heard no discussion of eliminating regulatory arbitrage. I heard no discussion of consolidating the consumer protection approach in any fashion to make it more effective. I heard no discussion of any systemic approach to improving consumer protection regulation. I heard the regulators are getting a little better, so we might as well leave things as they are.

That is not going to work given the current situation. We need something broader, and we need an agency that is focused just on consumers.

Senator MENENDEZ. So it just seems to me that when we go down the list of questions of what the average consumer might find themselves in, we see the incentives, for example, in the mortgage crisis for lenders to move people into products that, at the end of the day, may be very beneficial to them but not very beneficial to the consumer. And when millions of people enter into those transactions and then have consequences when those first 5 years end and cannot meet their obligations, then we have systemic challenges to our economy.

So it just seems to me why should we have the borrowers simply fend for themselves? I believe all in personal responsibility. I would love us to have greater financial literacy commitments as a country from education, to engagement, even our financial institutions to do so. But at the end of the day, if we allow millions of people based upon incentives that move individuals to try—entities to try to move individuals to products that are good for the lender and/or the broker but bad for the consumer and millions ultimately make a mistake and then create the consequences that we have today in the housing market, it affects all of us.

Mr. PLUNKETT. Well, Senator, I hope that when we heard discussion today about choices, we were not hearing about choices like the large number of minority consumers who were steered into high-cost mortgage loans when they could have afforded and would have qualified for a lower-cost loan. I hope we are not talking about choices like what Congress has just eliminated in the credit card bill, not just double-cycle billing but interest rate increases on existing balances for no apparent reason. I mean, that is called "negative financial engineering." That is not legitimate innovation. And that is the kind of, unfortunately, choice in many credit areas that has driven out positive credit, credit offered by some of the small banks you mentioned or credit unions.

Senator MENENDEZ. Well, Mr. Chairman, I hope that we will—you know, I do have concerns about how we structure this in a way that affects community banks that clearly have not been at the forefront of our economic challenges. We need to look at that.

I do get concerned about how we harmonize the State regulator process with these efforts.

And, third, I do want to see—I think Mr. Yingling does make a very valid comment that we have to apply—if we are going to have this consumer protection agency, which I generally support, it has to be applied across the spectrum of financial service entities; otherwise, we would do a disservice to the consumer, to the Nation, and certainly to the industry as well. So I look forward to working toward those goals.

Senator REED. Thank you, Senator Menendez.

Senator Shelby, you have a comment?

Senator SHELBY. I have got a couple of scenarios here that I think we ought to consider. In case one, a borrower obtains a subprime loan, the only loan he could qualify for, and uses it to buy property and then realizes a 75-percent gain on the property 3 years later. This goes on.

In case two, a borrower obtains a subprime loan in another market. This borrower has all the same credit and income characteristics at the time he received the loan as the borrower in the first

scenario, but later loses his job, sees the real estate market collapse, and then defaults.

I believe we need a system where we can accommodate both. How do we do that? In other words, the first guy—and this goes on—took a subprime loan and he made money out of it. Good for him, good probably for the market. The second one, he had the same qualifications, but things turned sour on him. He lost his job, and then he could not make the payments and so forth.

How do we do this? Mr. Wallison, do you have any—how do we balance this, I guess?

Mr. WALLISON. I think, Senator Shelby, you are focusing on exactly the problem here, which is trying to determine in advance what a person understands. The first person you are talking about—that consumer—may or may not have understood all of the elements of this loan, but it worked for him. It might not even have been the best loan he could have gotten, but it still worked for him. In the second case, it did not work for him.

I am looking at it, again—and I must do this because we have to consider the way this works in practice—from the standpoint of the provider. The provider is going to be very much at risk if he offers a loan to the first or the second person—the same loan——

Senator SHELBY. That is right.

Mr. WALLISON. Which goes beyond the plain-vanilla structure. If he does, the second guy—who did not make any money—is going to come back to him and complain about that or complain to the CFPA about him. And providers have to worry about this because they can be driven out of business very easily.

Senator SHELBY. By litigation.

Mr. WALLISON. By an enforcement action or a litigation or by a State Attorney General. So I think when the Committee is looking at this, you have to look at it from the standpoint of both the consumer and the provider, because the provider's decisions on whether to make these loans will affect very much what the consumer can get.

Senator SHELBY. Thank you.

Mr. MULLAINATHAN. If I may, I would like to add two comments to that, if I——

Senator REED. Quickly.

Mr. MULLAINATHAN. Quickly. One comment is providers are in the business already of detecting whether consumers understand or not. It would be unfortunate if a consumer took out a loan they could not repay. So one of the things providers do is actually assess whether the person—a good provider, whether the person understands the payments owed to them. So I do not think this is novel business practice.

Second, I think we have to ask the question who should bear the risk of a consumer not understanding. I think part of the risk should be borne by the consumer, but some of the risk should be borne by the firm. So I think the question is, do we leave the tilt of the balance all on the consumer or do we say the firm bears some of the risk as well of a consumer not understanding.

Thank you.

Senator REED. Thank you very much.

Senator Merkley has joined us, but he has been very gracious, and I just want to make two comments. I think the testimony has been excellent. We have several challenges. The two primary ones are ensuring there is a comprehensive form of consumer protection, which has been proposed in one agency. And then a second issue is the authority of that agency to conduct the operations. Those I think are the two basic issues.

I think also, too, I would just point out for the record that there is no private right of action included in this proposal. So there might be complaints to regulators, but the suggestion that this is going to set off a wave of private claims it not included in the legislation.

Also, I think the presumption at least that I start out with is that this agency will be subsuming the existing legislation authority of the Fed, of the different regulators, not have sort of an open-ended sort of role in crafting any sort of ideas they want. Truth in Lending Act, HOEPA, all those things now would shift—that legislation, that authority would shift to the agency.

So I again want to thank you all, and I particularly want to thank Senator Merkley, because I think we are ready to go. Thank you, gentlemen.

The hearing is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Good morning. Thank you all for being here today.

This morning, we are taking an important step in our efforts to modernize our financial regulatory system. The failure of that system in recent years has left our economy in peril and caused real pain for hard-working Americans who did nothing wrong.

The important work we do on this Committee is often complex and painstaking in its detail.

And so, I'd like to start by reminding everyone that the work we do here, the details, matter to real people, the men and women in my home State of Connecticut and across America who work hard, play by the rules, and want nothing more than to make a better life for their families.

These families are the foundation of our economy and the reason we're here in Washington working on this historic and critically important legislation.

That's why the first piece of the Administration's comprehensive plan to rebuild our regulatory regime and our economy is something I have championed: an independent agency whose job it will be to ensure that American consumers are treated fairly and honestly.

Think about the moments when Americans engage with financial service providers. I'm not talking about big-time investors or financial experts, just ordinary working people trying to secure their futures. They're opening checking accounts, taking out loans, building their credit, trying to build a foundation upon which their family's economic security can rest.

These can be among the most important and stressful moments a family can face.

Think of a young couple. They've carefully saved up for a down payment. It might be a modest house—but it'll be their home. Before they can move into their new home, however, they must sign on the dotted line for that first mortgage with its pages and pages of complex and confusing disclosures.

Who's looking out for them?

Think of a factory worker who drives 30 miles to and from work every day in an old car that's about to give out. He needs another one to make it through the winter, but his wages are stagnant and the family budget is stretched to the max. He's got no choice but to navigate the complicated world of auto loans.

Who's looking out for him?

Think of a single mother whose 17-year-old son just got into his top choice of colleges. She's overjoyed for him, but worried about how she'll pay the tuition. Financial aid might not be enough, and she knows that even as her son begins the next chapter in a life filled with promise, he might be saddled with debt.

Who's looking out for them?

These moments are the reason we have invested so much time and money to rebuild our financial sector even though some of the very same institutions the taxpayers have propped up are responsible for their own predicaments. These moments are the reason we serve on this Committee.

And these moments are the reason I and many of my colleagues were enraged at the spectacular failure of consumer protection that destroyed the economic security of so many American families.

In my home State of Connecticut and around the country, working men and women who did nothing wrong have watched this economy fall through the floor—taking with it jobs, homes, life savings, and the cherished promise of the American middle class.

These folks are hurting, they are angry, they are worried. And they are wondering: Is anyone looking out for me?

Since the very first hearing before this Committee on modernizing our financial regulatory structure, I have said that consumer protection must be a top priority.

Stronger consumer protection could have stopped this crisis before it started.

And where were the regulators? For 14 years, despite a clear directive from Congress, the Federal Reserve Board took no action to ban abusive home mortgages. Gaping holes in the regulatory fabric allowed mortgage brokers and bankers to make and sell predatory loans to Wall Street that turned into toxic securities and brought our economy to its knees.

That is why I called for the creation of an independent consumer protection agency whose sole focus is the financial well-being of consumers; an agency whose goal is to put an end to unscrupulous lenders and practices that have ripped off far too many American families.

And I'm pleased that the Administration has sent us a bold and thoughtful plan for that agency.

You would think financial services companies would support protections that ensure the financial well-being of their customers—if not out of concern for their own bottom-lines, then out of simple common decency.

But now I read that various industry groups are planning a major PR offensive in an effort to kill this consumer protection agency.

To those who helped create this mess and now plan to flood the airwaves with misleading propaganda, I have just two words for you: Get real.

The forces of the *status quo* can run as many "Harry and Louise" ads as they want. But Harry and Louise are exactly why we're moving forward on this proposal.

We can't have a functioning economy if Harry and Louise can't safely invest and borrow without fear of being cheated by greedy banks and Wall Street firms. And we will not have a financial regulatory modernization bill that doesn't provide the protections American families need and deserve.

An independent consumer protection agency can, and should, be good for business.

It can, and should, protect the financial well-being of American consumers so that businesses can rely on a healthy customer base as they seek to build long-term profitability.

It can, and should, eliminate the regulatory overlap and bureaucracy that comes from the current balkanized system of consumer protection regulation.

It can, and should, level the playing field by applying a meaningful set of standards, not only to the highly regulated banks, but also to their nonbank competitors that have slipped under the regulatory radar screen.

Financial services companies that want to make an honest living should welcome this effort to create a level playing field.

Indeed, the good lenders are the most disadvantaged when fly-by-night brokers and finance companies set up shop down the street. Then we see bad lending pushing out the good.

No Senator on this Committee wants to stifle product innovation, limit consumer choice, or create regulation that is unnecessary or unduly burdensome.

And I welcome constructive input from those in the financial services sector who share our commitment to making sure that American families get a fair shake.

But I do not view as constructive the opposition to the creation of this agency by some industry groups in order to, as Bloomberg News reported, "protect their fees."

We all want financial services companies to thrive and succeed, but they will have to make their money the old fashioned way—by developing innovative products, pricing competitively, providing excellent customer service, and engaging in fair competition on the open market.

The days of profiting from misleading or predatory practices are over.

The path to recovery of our financial services companies and our economy is based on the financial health of American consumers.

We need a system that rewards products and firms that create wealth for American families, not one that rewards financial engineering that generates profits for financial firms by passing on hidden risks to investors and borrowers.

The fact that the consumer protection agency is the first legislative item the Administration has sent to Congress since it released its white paper on regulatory reform last month tells me that our President's priorities are in the right order.

I wish I could say the same for everyone in the industry.

Nevertheless, with the backing of the Administration, with the support of many in the financial community who understand the importance of this reform, and, most of all, with a mandate from the American families who count on a fair and secure financial system, we will push forward.

I thank you all for being here today. Now let's get to work.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you Mr. Chairman for holding today's hearing. This hearing could be one of the most important held this month as the Committee takes up legislation to modernize our financial regulatory system.

The current economic crisis has exposed regulatory gaps that allowed institutions to offer products with minimal regulation and oversight. Many of these products were not just ill-suited for consumers, but were disastrous for American homeowners. There is a clear need to address the failures of our current system when it comes to protecting consumers. We need to find the correct balance between consumer protection, innovation, and sustainable economic growth.

There is no doubt that the *status quo* is not acceptable. However, as Congress considers proposals to improve the protection of consumers from unfair, deceptive, and predatory practices, we must ask many important questions. We need to know if it

is the right thing to do to separate consumer protection from functional regulation. We need to know if a separate, independent consumer protection agency is better than a consumer protection division within an existing regulatory agency. We need to know who should be writing rules for consumer products and who should be enforcing those rules. We need to know if national standards or 51 set of rules made by each State are better for consumers. Last, while the goal of any consumer protection agency is clearly better protection of consumers, we need to know if it will also preserve appropriate access to credit for the consumers it is designed to protect.

The creation of a new agency is a daunting task under any circumstances; even more so in this case, considering the role a consumer protection agency would play in our Nation's economic recovery. It is important we get this right. I look forward to hearing from today's witnesses.

PREPARED STATEMENT OF MICHAEL S. BARR

ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS,
DEPARTMENT OF THE TREASURY

JULY 14, 2009

Thank you, Chairman Dodd and Ranking Member Shelby, for providing me with this opportunity to testify about the Administration's proposal to establish a new, strong financial regulatory agency charged with just one job: looking out for consumers across the financial services landscape.

The need could not be clearer. Today's consumer protection regime just experienced massive failure. It could not stem a plague of abusive and unaffordable mortgages and exploitative credit cards despite clear warning signs. It cost millions of responsible consumers their homes, their savings, and their dignity. And it contributed to the near collapse of our financial system. We did not have just a financial crisis; we had a consumer crisis. Americans are still paying the price, and those forced into foreclosure or bankruptcy or put through other wrenching dislocations will pay for years.

There are voices saying that the *status quo* is fine or good enough. That we should keep the bank regulators in charge of protecting consumers. That we just need some patches. They even claim consumers are better off with the current approach.

It is not surprising we are hearing these voices. As Secretary Geithner observed last week, the President's proposals would reduce the ability of financial institutions to choose their regulator, to shape the content of future regulation, and to continue financial practices that were lucrative for a time, but that ultimately proved so damaging. Entrenched interests always resist change. Major reform always brings out fear mongering. But responsible financial institutions and providers have nothing to fear.

We all aspire to the same objectives for consumer protection regulation: independence, accountability, effectiveness, and balance. The question is how to achieve them. A successful regulatory structure for consumer protection requires mission focus, marketwide coverage, and consolidated authority.

Today's system has none of these qualities. It fragments jurisdiction and authority for consumer protection over many Federal regulators, most of which have higher priorities than protecting consumers. Nonbanks avoid Federal supervision; no Federal consumer compliance examiner lands at their doorsteps. Banks can choose the least restrictive supervisor among several different banking agencies. Fragmentation of rule writing, supervision, and enforcement leads to finger-pointing in place of action and makes actions taken less effective.

The President's proposal for one agency for one marketplace with one mission—protecting consumers—will resolve these problems. The Consumer Financial Protection Agency will create a level playing field for all providers, regardless of their charter or corporate form. It will ensure high and uniform standards across the market. It will end profits based on misleading sales pitches and hidden traps, but there will be profits made on a level playing field where banks and nonbanks can compete on the basis of price and quality.

If we create one Federal regulator with consolidated authority, we will be able to leave behind regulatory arbitrage and interagency finger-pointing. And we will be assured of accountability.

Our proposal ensures, not limits, consumer choice; preserves, not stifles, innovation; strengthens, not weakens, depository institutions; reduces, not increases, regulatory costs; and increases, not reduces, national regulatory uniformity.

Successful consumer protection regulation requires mission focus, marketwide coverage, and consolidated authority

Consumer protection regulation should be effective and balanced, independent and accountable. It can be none of these without three essential qualities: mission focus, marketwide coverage, and consolidated authority.

First, consumer protection regulation requires mission focus. A clear mission is the handmaiden of accountability. It is also the basis for the expertise and effectiveness that are essential to maintaining independence.

Second, the regulator must have marketwide jurisdiction. This ensures consistent and high standards for everyone. And it prevents providers from choosing a less restrictive regulator. Carving up markets in artificial, noneconomic ways is a recipe for weak and inconsistent consumer protection standards and captured regulators.

Third, authorities for regulation, supervision, and enforcement must be consolidated. A regulator without the full kit of tools is frequently forced to choose between acting without the right tool and not acting at all. Moreover, if different regulators have different authorities, each can point the finger at the other instead of acting, and the sum of their actions will be less than the parts. The rule writer that does not supervise providers lacks information it needs to determine when to write or revise rules, and how best to do so. The supervisor that does not write rules lacks a marketwide perspective or adequate incentives to act. Splitting authorities is a recipe for inertia, inefficiency, and unaccountability.

The present system of consumer protection regulation is designed for failure

The present system of consumer protection regulation is not designed to be independent or accountable, effective or balanced. It is designed to fail. It is simply incapable of earning and keeping the trust of responsible consumers and providers.

Today's system does not meet a single one of the requirements I just laid out: mission focus, marketwide coverage, or consolidated authority. It does not even come close. The system fragments jurisdiction and authority for consumer protection over many Federal regulators, most of which have higher priorities than protecting consumers. Nonbanks avoid Federal supervision and banks can choose the least restrictive supervisor among several different banking agencies. Fragmentation of rule writing, supervision, and enforcement among several agencies lead to finger-pointing in place of action and make actions taken less effective.

This structure is a welcome mat for bad actors and irresponsible practices. Responsible providers are forced to choose between keeping market share and treating consumers fairly. The least common denominator sets the standard, standards inevitably erode, and consumers pay the price. Let me spell out these failures in more detail.

Lack of mission focus: Protecting consumers is not the banking agencies' priority. The primary mission of Federal banking agencies, in law and in practice, is to ensure that banks act prudently so they remain safe and sound. Ensuring that banks act transparently and fairly with consumers is not their highest priority. Consumer protection regulation and supervision was added to the agencies' responsibilities relatively late in their histories, and it has never fit snugly in their missions, structures, or agency cultures.

In fact, consumer protection supervision is generally conducted through the prism of bank safety and soundness. The goal of such supervision has too often been to protect banks or thrifts from excessive litigation or reputation risk, rather than to protect consumers. It was thought that supervising the banks for their effective management of "reputation risk" and "litigation risk"—aspects of a safe and sound institution—would ensure the banks treated their customers fairly. It didn't. It did not prevent our major banks and thrifts from retroactively raising rates on credit cards as a matter of policy, or from selling exploding mortgages to unwitting consumers as a business expansion plan.

It should not have come as a surprise that the agencies' "check-the-box" approach to consumer compliance supervision missed the forest for the trees. Examiners are well trained to ascertain whether the annual percentage rate on a loan is calculated as prescribed and displayed with a large enough type size. Equally or more important questions—Could this consumer reasonably have understood this complicated loan? Is this risky loan remotely suitable for this consumer?—are not a priority for an agency whose main job is to limit risks to banks, not consumers.

Managing risks to the bank does not and cannot protect consumers effectively. This approach judges a bank's conduct toward consumers by its effect on the bank, not its effect on consumers. Consumer protection regulation must be based first and foremost on a keen awareness of the perspectives and interests of consumers, and a strong motivation to understand how products and practices affect them—for good

and for bad. Agencies charged primarily with safeguarding banks will lack this awareness or motivation.

Fragmented jurisdiction: There are two regulatory regimes for one market, and nonbanks escape Federal supervision. There is one market for residential mortgages, one market for consumer credit, and one market for payment services—but two different and uncoordinated regimes for these and other consumer financial products and services. Banks are subject to an extensive supervisory regime, with lengthy and intensive consumer compliance examinations on-site and off-site as well as a legal obligation to respond to requests for internal information.

This regime, when it works, identifies and resolves weaknesses in banks' consumer protection systems before they harm consumers. The major failures of this regime were not for lack of examination hours or paperwork burdens. Failures occurred for lack of asking the right questions and taking the right perspective. These failures were rooted in the absence of mission focus. A Federal regime of consumer compliance supervision can be very effective in the right hands.

Nonbank providers, however, are not subject to any Federal supervision. No Federal regulator sends consumer compliance examiners to nonbank providers to review their files or interview their salespeople. Nor does any Federal regulator regularly collects information from them, except limited mortgage data.

Nonbank providers are subject only to after-the-fact, targeted investigations and enforcement actions by the Federal Trade Commission or State attorneys general. Supervision by the States of these providers is limited, uneven, and not necessarily coordinated. In general the same Federal consumer protection laws apply to this sector as apply to banks, but lack of Federal supervision and inherent limitations of the after-the-fact approach of investigations and enforcement resources leave the sector much less closely regulated.

Lack of Federal supervision of nonbanks brings down standards across the board. Capital and financing flow to the unsupervised sector in part because it enjoys the advantages of weak consumer oversight. Less responsible actors face good odds that the FTC and State agencies lack the resources to detect and investigate them. This puts enormous pressure on banks, thrifts, and credit unions to lower their standards to compete—and on their regulators to let them.

This is precisely what happened in the mortgage market. Independent mortgage companies and brokers grew apace with little oversight; capital and financing flowed their way. The independents peddled subprime and exotic mortgages—such as "option ARMs" with exploding payments and rising loan balances—in misleading ways, to consumers demonstrably unable to understand or handle their complex terms and hidden, costly features. The FTC and the States took enforcement actions, but their resources were no match for rapid market growth. And they could not set rules of the road for the whole industry, or examine institutions to uncover bad practices and prevent their spread.

To compete over time, banks and thrifts and their affiliates came to offer the same risky products as their less regulated competitors and relaxed their standards for underwriting and sales. About one half of the subprime originations in 2005 and 2006—the shoddy originations that set off the wave of foreclosures—were by banks and thrifts and their affiliates. Lenders of all types paid their mortgage brokers and loan officers more to bring in riskier and higher-priced loans, with predictable results. Bank regulators were slow to recognize these problems, and even slower to act. The consequences for homeowners were devastating, and our economy is still paying the price.

Mortgages are the most dramatic example of the harm that regulatory fragmentation causes consumers, but not the only one. Take the case of short-term, small-dollar credit. Payday lenders have grown rapidly outside the banking sector. They are not typically subject to State examinations or information collections. On the other side of the bank–nonbank divide, banks compete in the short-term, small-dollar credit market with cash advances on credit cards and "overdraft protection" programs.

Each one of these three competing products is disclosed to the consumer differently, and each has been associated with abusive or unfair practices. There is a clear need for a consistent approach to regulating short-term, small-dollar credit that protects consumers while ensuring their access to responsible credit—but our fragmented system cannot deliver.

The list goes on. A wide range of credit products are offered—from payday loans to pawn shops, to auto loans and car title loans, many from large national chains—with little supervision or enforcement. Credit unions and community banks with straightforward credit products struggle to compete with less scrupulous providers who appear to offer a good deal and then pull a switch on the consumer.

Banks and thrifts can—and do—choose the most permissive supervisor, further depressing standards. Just as capital flows from the bank sector to the nonbank sector in search of less regulation, banks and thrifts can freely choose their Federal supervisor on the basis of which one has less restrictive oversight of consumer compliance. We saw this choice in action during the mortgage boom.

But institutions do not actually have to switch supervisors to bring down standards. The mere fact that institutions have a choice exerts a subtle but pernicious drag on standards. It has little to do with who runs the agency. It is simply that Government agencies, like all other organizations, respond to incentives. The banking agencies, naturally, seek to retain or even compete to gain "market share."

Incomplete and fragmented supervision delays and impedes responses to emerging problems. When a consumer protection problem emerges, a new regulation is not necessarily the first and best response. It takes many months, even years, to adopt a new rule. And rules are often fairly rigid, detailed, and technical, especially if the underlying statute allows private suits. Supervisory guidance can be a much faster and more flexible, principles-based method to prevent problems.

But guidance is a much weaker tool than it should be because of incomplete and fragmented Federal supervisory authority. There is no Federal supervision over nonbanks, and supervision of banks is divided among several agencies. This means that any effort to use supervisory guidance requires a massive and prolonged effort to bring many different Federal bank regulators, and State regulators of bank and nonbank institutions, to agreement on the precise wording of the document.

It took the Federal banking agencies until June 2007 to reach final consensus on supervisory guidance imposing even general standards on the sale and underwriting of subprime mortgages—two years after evidence of declining underwriting standards emerged publicly in a regulator's survey of loan officers. By that time the subprime explosion was nearly over. It took additional time for States to adopt parallel guidance for independent mortgage companies. And it took a third year for the Federal agencies to settle on a model disclosure of subprime mortgages, by which point the subprime market had long ago imploded.

Fragmented authorities: Rule writing is divided across agencies and largely divorced from enforcement and supervision. Fragmented rule-writing authority produces delays and inefficiencies. Separation of rule writing from supervision and enforcement invites finger-pointing in place of action and reduces the effectiveness of actions taken.

Rule-writing authority is fragmented, producing delays and inefficiencies. While authority to write most Federal consumer protection regulations is exclusively in the Federal Reserve, other agencies have joint or concurrent authority to implement several statutes. It is a recipe for delay and inefficiency.

For example, HUD and the Federal Reserve each implement a different statute governing mortgage disclosure, the Real Estate Settlement Procedure Act and Truth in Lending Act, respectively. The result is two forms emphasizing different aspects of the same transaction and using different language to describe some of the same aspects. It has been 11 years since the agencies recommended an integrated form. Even if they succeed in adopting an integrated form, their ability to act jointly to keep it up-to-date as the market changes will be limited at best.

As another example, Congress mandated joint or coordinated rulemaking by six Federal agencies under the Fair and Accurate Credit Transactions Act of 2003 to improve the accuracy of information reported to credit bureaus and, to establish procedures for consumers to file disputes with information furnishers. Those agencies published final rules less than two weeks ago, on July 1, 2009. Clearly consumers deserve faster action on issues as important in their financial lives as accuracy of credit reports.

Rule writing is divorced from enforcement and supervision, causing inertia and undermining effectiveness. The authority to write regulations implementing the Federal consumer protection statutes is largely divorced from the authority for supervision and enforcement. This deprives the rule writer of critical information about the marketplace that is essential to effective and balanced regulation.

That is one reason we did not have Federal regulations for the subprime market. The Federal Reserve has authority to write regulations under the Truth in Lending Act and Homeownership and Equity Protection Act to ensure proper disclosure and prevent abusive lending. But it cannot examine, obtain information from, or investigate independent mortgage companies or mortgage brokers. So it is not surprising that the agency was slow to recognize the need for new subprime regulations. By the time it proposed rules, the subprime market had evaporated.

The separation of rule writing from supervision and enforcement also leads to finger-pointing and inertia. Take the case of credit cards. Some banks found they could boost fee and interest income with complex and opaque terms and features that

most consumers would not notice or understand. These tricks enabled banks to advertise seductively low annual percentage rates and grab market share. Other banks found they could not compete if they offered fair credit cards with more transparent pricing. So consumers got retroactive rate hikes, rate hikes without notice, and low-rate balance transfer offers that trapped them in high-rate purchase balances.

A major culprit, once again, was fragmented regulation: One agency held the pen on regulations, another supervised most of the major card issuers. Each looked to the other to act, and neither acted until public outrage reached a crescendo. By then it was too late for millions of debt-entrapped consumers.

There is only one solution to these deep structural flaws: One regulator for one market with one mission—protecting consumers—and the authority and resources to achieve it

These deep structural flaws cannot be solved by tinkering with the consumer protection mandates or authorities of our existing agencies. The structure itself is the problem. There are too many agencies with consumer protection responsibilities, their authorities are too divided, and their primary missions are too distant from consumer protection.

These problems have only one effective solution: a single Federal financial consumer protection agency. We need one agency for one marketplace with one mission—to protect consumers of financial products and services—and the authority to achieve that mission.

A new agency with a focused mission, comprehensive jurisdiction, and broad authorities is the only way to ensure consumers and providers high and consistent standards and a level playing field across the whole marketplace without regard to the form of a product—or the type of its provider. It is the only way to ensure independence, accountability, effectiveness, and balance in consumer protection regulation.

The CFPA will have one mission: To protect consumers. Mission focus will not be a problem for this agency. It will have no other mission that competes for attention or resources. And it will have the resources it needs to fulfill this mission and maintain its independence. The agency will have a stable funding stream in the form of appropriations and fee assessments akin to those regulators impose today.

A mission of protecting consumers requires weighing competing considerations. Our proposal explicitly recognizes this complexity. It charges the CFPA with requiring effective disclosures and preventing abusive or unfair practices; and it also charges the CFPA with ensuring markets are efficient and innovative and preserving consumers' access to financial services. A statutory mandate to weigh these potentially competing considerations will help ensure the CFPA's regulations are balanced.

The banking agencies will be able to concentrate their attention on bank safety and soundness. The Federal Reserve will be able to focus on monetary policy, financial stability, and holding company supervision without the major distractions it has experienced because it holds the pen on most major consumer protection regulations.

The CFPA will have jurisdiction over the entire market. Our proposal for comprehensive jurisdiction will ensure accountability. The CFPA will not have the luxury of pointing the finger at someone else. If a problem arises in the nonbank sector, the agency will be as accountable as it will be for problems in the banking sector.

Comprehensive jurisdiction will also make regulatory arbitrage a thing of the past. Providers will not have a choice of regulators. So, by definition, they will not be able to choose a less restrictive regulator. The CFPA will not have to fear losing "market share" because our legislation gives it authority over the whole market. Ending arbitrage will prevent the vicious cycles that weaken standards across the market.

Comprehensive jurisdiction will protect consumers no matter with whom they do business, and level the playing field for all institutions and providers. For the first time, a Federal agency would apply to nonbank providers the tools of supervision that regulators now apply to banks—including setting compliance standards, conducting compliance examinations, reviewing files, obtaining data, issuing supervisory guidance and entering into consent decrees or formal orders. With these tools, the Agency would be able to identify problems before they spread, stop them before they cause serious injury, and relieve pressures on responsible providers to lower their standards.

The CFPA's marketwide perspective and authority will help it work with the States to target Federal and State examination resources to nonbank providers based on risks to consumers. The CFPA can set and enforce national standards and

supplement State efforts with its own examiners and analytics. The agency will be able to use efficient supervisory techniques in the nonbank sector such as risk-based examinations. The CFPA will provide leadership to the States, improve information sharing, and leverage State resources. The FTC will continue to have full authority to investigate and stop financial frauds.

The CFPA will have the full range of authorities: Rule writing, supervision, and enforcement. CFPA's regulations will be based on a deep understanding of markets, providers, and products gained from the power to examine and collect information from the full range of bank and nonbank financial service providers. Combining rule-writing authorities with supervision and enforcement authorities in one agency will ensure faster and more effective rules.

Where speed and flexibility are at a high premium, the CFPA will be able to exploit the full potential of supervisory guidance to address emerging concerns. Years-long delays to issue guidance because of interagency wrangling will be a thing of the past.

For example, the CFPA will both implement the new Credit CARD Act of 2009—to ban retroactive rate hikes and rate hikes without notice—and supervise the credit card banks for compliance. So the agency will have a feedback loop from the examiners of the banks to the staff who write the regulations, allowing staff to determine quickly how well the regulations are working in practice and whether they need to be tightened or adjusted. It will also be able to improve credit card practices with supervisory guidance.

The CFPA's rule-writing authority will be comprehensive and robust. The CFPA will be able to write rules for all consumer financial services and products and anyone who provides these products. (Its authority will not extend to entities registered with the Securities and Exchange Commission when these entities are acting within their registered capacities.) The CFPA will assume existing statutory authorities—such as the Truth in Lending Act and Equal Credit Opportunity Act. New authorities we propose—to require transparent disclosure, make it easier for consumers to choose simple products, and ensure fair terms and conditions and fair dealing—will enable the agency to fill gaps as markets change and to provide strong and consistent regulation across all types of consumer financial service providers.

For example, our proposal gives the CFPA the power to strengthen mortgage regulation by requiring lenders and brokers to clearly disclose major product risks, and offer simple, transparent products if they decide to offer exotic, complex products. The CFPA will also be able to impose duties on salespeople and mortgage brokers to offer appropriate loans, take care with the financial advice they offer, and meet a duty of best execution. And it will be able to prevent lenders from paying higher commissions to brokers or salespeople ("yield spread premiums") for delivering loans with higher rates than consumers qualify for. Lenders and consumers would finally have an integrated mortgage disclosure.

Comprehensive standard-setting authority would improve other markets, too. For example, the CFPA could adopt consistent regulations for short-term loans—establishing disclosure requirements—whether these loans come in the form of bank overdraft protection plans or payday loans or car title loans from nonbank providers. The agency also could adopt standards for licensing and monitoring check cashers and pawn brokers.

The new CFPA will bring higher and more consistent standards; stronger, faster responses to problems; the end of regulatory arbitrage; a more level playing field for all providers; and more efficient regulation. A dedicated consumer protection agency will help restore the trust and confidence on which our financial system so critically depends.

The CFPA will ensure, not limit, consumer choice; preserve, not stifle, innovation; strengthen, not weaken, depository institutions; and reduce, not increase, regulatory burden; and increase, not reduce, uniformity

The CFPA will ensure, not limit, consumer choice. The agency will have a mandate to promote simplicity. It will also be charged with preserving efficient and innovative markets and consumer access to financial services and products. The point is to make it easier for consumers to choose simpler products while preserving their ability to choose more complex products if they better suit consumers' needs.

For example, the CFPA will have the authority to require providers that offer exotic, complex, and riskier products to offer at least one standard, simple, less risky product. In the mortgage market, a lender or broker that peddles mortgages with potentially exploding monthly payments, hidden fees and prepayment penalties, and growing loan balances—such as the "pay option ARMs" of recent years—might also be required to offer consumers 30-year, fixed-rate mortgages or conventional ARMs with straightforward terms.

The idea is not new. A division between "traditional" and "nontraditional" products is deeply embedded in our mortgage markets. A similar consensus about standard and alternative products may emerge in other product markets. The CFPA's rigorous study of consumer understanding and product performance may help produce a consensus in a given market about the appropriate dividing line.

This approach, to be sure, may not work in all contexts. Our draft legislation requires the agency to consider its effect on consumer access to financial services or products. In some cases the costs may outweigh the benefits—that will be for the agency to determine. In other cases, using this approach will obviate the need for costlier restrictions on terms and practices that would limit consumer choices.

The CFPA will preserve, not stifle, innovation. The present regulatory system clearly failed to strike the right balance between financial innovation and efficiency, on the one hand, and stability and protection, on the other. This imbalance was a major cause of the financial crisis. Ensuring that consumers who want simple products can get them, and that consumers who take complex products understand their risks, will re-right the scales.

The benefits of innovation will continue to flow. By helping ensure that significant risks are assumed only by knowing and willing consumers, the CFPA will improve confidence in innovation and make it sustainable rather than tied to quarterly results.

The CFPA will strengthen, not weaken, depository institutions. Protecting consumer is not unsafe or unsound for banks. Protecting consumers is good for banks. If we had protected consumers from banks that sold risky mortgages like option ARMs in misleading ways, then we would have made the banks more sound, not less.

We reject the notion that profits based on unfair practices are sound. The opposite appears true. Massive credit card revenue, for example, was not sustainable. It depended on unfair practices that bore the seeds of their own demise. These practices led this Congress to pass, and President Obama to sign, tough new restrictions on credit cards.

Examiners in the field will resolve the rare conflict that arises just as they do today. For larger banks, CFPA examiners could reside in the bank just as consumer compliance examiners often do today, right next door to safety and soundness examiners. They would regularly share information—our draft legislation mandates the exchange of examination reports—and coordinate approaches. Moreover, the CFPA could work with the banking agencies to ensure bank consumer compliance examiners are trained to understand safety and soundness, as they are today.

For the even rarer conflict that arises and cannot be resolved on the ground, our proposal provides mechanisms for its resolution. A safety and soundness regulator will have one of five board seats, ensuring a strong voice within the agency for prudential concerns. In addition, the agency must consult with safety and soundness regulators before adopting rules. The Financial Services Oversight Council will bring these agencies together on a regular basis.

The CFPA will reduce, not increase, regulatory costs. The CFPA is not a new layer of regulation; it will consolidate existing regulators and authorities. I have already discussed the tremendous benefits this will bring to responsible providers by ensuring consistent standards and a level playing field. And consolidating authority does not just increase accountability for protecting consumers, it also increases accountability for removing unnecessary regulatory burdens.

Consolidation will also bring direct efficiencies. The agency would help to simplify and reduce regulatory burdens in areas where current authorities overlap or conflict. For instance, the agency would ensure we have a single Federal mortgage disclosure—eliminating confusing and unnecessary paperwork.

Other efficiencies will flow from the CFPA's ability to choose the best tool for the problem. The agency's authority to restrict terms and conditions of contracts by regulation—as the Congress did in the Credit CARD Act of 2009—will be just one of many authorities. With comprehensive supervisory authority over the whole market, the agency will also be able to use more flexible, potentially less costly tools such as supervisory guidance.

The breadth and diversity of the authorities we propose will ensure the agency can tailor its solution to the underlying problem with the least cost to consumers and institutions. The agency will have ample authority to harness the benefits of market discipline by improving the quality of, and access to, information in the marketplace. The CFPA will have authority to ensure that consumers receive relevant and concrete information in a timely manner. These measures, and measures that make it easier for consumers to choose simpler products, should reduce the need for more burdensome regulations.

Imposing Federal supervisory authority on nonbank institutions for the first time will increase compliance requirements on that sector. But this is well worth the benefit of higher and more consistent standards.

The CFPA will increase, not reduce, national regulatory uniformity. The CFPA's rules and regulations will set a floor for the States, not a ceiling. The contention that this will somehow increase variations in State laws is a red herring. Our proposal does not alter the law of the *status quo:* major Federal consumer protection statutes such as the Truth in Lending Act and Homeownership and Equity Protection Act explicitly make Federal regulations a floor, not a ceiling.

In fact, a strong Federal consumer protection regulator should be able to increase regulatory uniformity. States sometimes adopt new financial services laws because they perceive a lack of Federal will and leadership. That is exactly what happened in the mortgage context, where States filled a vacuum of predatory mortgage law with State statutes and regulations. If the States believe an expert, independent Federal agency is on the job and working with the States to protect their consumers, the States will feel less need to adopt new laws.

Conclusion

We need consumer protection regulation that is independent and accountable, effective and balanced. These goals are achievable, but only if we address fundamental flaws in the structure of consumer protection. The only real solution to these flaws is creating an agency with a focused consumer protection mission; comprehensive jurisdiction over all financial services providers, both banks and nonbanks; and the full range of regulatory, enforcement, and supervisory authorities.

It is time for a level playing field for financial services competition based on strong rules, not based on exploiting consumer confusion. And it is time for an agency that consumers—and their elected representatives—can hold fully accountable. The Administration's legislation fulfills these needs. Thank you for this opportunity to discuss our proposal, and I will be happy to answer any questions.

PREPARED STATEMENT OF RICHARD BLUMENTHAL

ATTORNEY GENERAL,
STATE OF CONNECTICUT

JULY 14, 2009

I appreciate the opportunity to strongly support the Administration's proposal to create a Federal agency dedicated solely to protecting consumer interests in financial products and markets, and preserve and expand State consumer protection authority.

The new agency—a consumer financial guardian—promises to be a powerful watchdog and protector, and a partner of State attorneys general in fighting for our citizens. The proposal marks a giant step toward restoring an historic Federal–State alliance in combating financial fraud and abuse. This Federal–State partnership was riven by excessive resort to Federal preemption—displacing State enforcement and replacing Federal–State collegiality and cooperation with relentless conflict.

The new agency is a necessary and appropriate response to exploding complexity, scope, and scale of new financial instruments and markets—and exponentially increasing impact on ordinary citizens. It fills a deeply felt consumer need. Ever more slick and sophisticated marketing—often misleading and deceptive—cannot be battled successfully by States alone, or the existing Federal agencies. Creating a new agency to fight consumer cons and abuse in alliance with the States, the Federal Government can muster more potent and proactive policing and prosecution.

A new consumer guardian—we need it, and now. New firepower, focus and drive, all are vital. The new agency will be more an enforcer, than a regulator. At the Federal level, the new agency would investigate law breaking and enable and assist Department of Justice prosecutions, both civil and criminal.

Unfortunately, some opponents of this agency have misrepresented its purpose. The Financial Consumer Protection Agency will not "regulate credit." It will not make choices for consumers or deny them access to products and services. Instead, one of its main missions will be to assure that consumers are informed in clear, layman's language of the terms and conditions of credit cards, mortgages, and loans. The point is to assure that consumers fully understand the financial realities and consequences of financial obligations, credit cards, or loans they are considering before they make commitments.

As even experienced lawyers and consumer protection advocates can attest, anyone attempting to understand their credit card agreements all too frequently faces incomprehensible, consuming small print with huge consequences. This agency's purpose is to assure people have good information so they can make good financial decisions. Once they use that information and make decisions, they will have to live with the consequences.

Federal Preemption Doctrine Disaster

For far too long, States have been forced to the sidelines, standing helplessly, while credit card, mortgage, and financial rescue companies used Federal preemption as a shield to stop State consumer protection agencies from enforcing State laws against unfair and unscrupulous practices. Connecticut consumers have been scammed by fraudulent and unfair marketing schemes and products by companies who create or affiliate with national banks solely to avoid State consumer protection laws.

Worse, Federal agencies have been complicit—aiding and abetting lawbreakers by supporting preemption claims when States sued to stop these unfair practices and recover consumer losses. Federal agencies went AWOL—not only disavowing their firepower but disarming State enforcers. They forced States from the battlefield and then abandoned it—in countless areas of consumer protection. They enabled and encouraged use of preemption as an impregnable shield to protect mortgage fraud, credit card abuses, securities scams, banking failure, and many deceptive and misleading snake oil pitches.

The financial meltdown was foreseeable—and foreseen—by enforcement authorities who warned of irresponsible and reprehensible retreat and surrender in Federal law enforcement. There were warnings—including mine—about a regulatory black hole concerning hedge funds, derivatives, credit default swaps, excess leverage devices and other practices. I used this term—regulatory black hole—to characterize lack of oversight and scrutiny that enabled self dealing, excessive risk-taking, and other abuses that sabotaged the system.

The national financial meltdown was directly due to massive Federal law enforcement failure—lax or dysfunctional Federal oversight and scrutiny of increasingly arcane, complex, opaque, risky practices and products. Federal law placed all enforcement and regulatory authority in an array of Federal agencies that were inept, underfunded, complacent or complicit. The result was a void or vacuum unprecedented since the Great Depression.

Robust State investigatory and enforcement authority no doubt would have revealed unfair and illegal activities sooner and helped fill the gap left by Federal inaction and inertia. Putting State cops on the consumer protection beat would have sent a message—educating the public, deterring wrongdoing, punishing lawbreakers.

Connecticut has been at the forefront of State efforts to protect consumers from unfair and fraudulent financial transactions. And two areas illustrate the obstacles that we and other States have faced under the current system.

Tax preparers use the lure of instant cash to entice taxpayers—mostly low income—to borrow money at extremely high interest rates, using their tax refund to pay these loans. Recognizing that Connecticut could not regulate such usurious lending by national banks, our State sought to cap at 60 percent the interest charged on loans made through a tax preparer' or other facilitator of the loan. The statute was challenged by lenders who charge more than 300 percent annual interest rate. As a former United States Attorney, I can tell you that organized crime would offer a better deal. The Federal Second Circuit Court of Appeals held that Connecticut law could not be applied to national banks or their agents. *Pacific Capital v. Connecticut,* 542 F.3d 341 (2d Cir. 2008). As a result, consumers continue to pay astronomical interest rates for such refund anticipation loans.

Second, even as gift cards have become increasingly popular in Connecticut and the country, consumers often see their cash value erode over time because of hidden inactivity fees or short expiration dates. In response, Connecticut prohibited both inactivity fees and expiration dates. Mall operators and retail chain stores avoided such consumer protection laws by merely contracting with national banks to issue gift cards. The Second Circuit Court of Appeals held that State consumer protection laws are preempted because the State measures affect a national bank rule. It ruled that Visa gift cards had expiration dates so the State could not prohibit them. *SPGGC v. Blumenthal,* 505 F.3d 183 (2d Cir. 2007). The result is pervasive consumer confusion because some gift cards issued by national banks may expire, but others have no such expiration dates.

Other States have faced similar preemption obstacles to protecting consumers. My colleague in Minnesota began investigating Capital One's credit card marketing

practices under the State's consumer protection laws. Capital One transferred all its credit card operations into a national bank, successfully halting the investigation, because Minnesota's consumer protection laws were preempted. Similarly, an Illinois investigation into Wells Fargo Financial's steering of minorities into high cost loans was stymied by Wells Fargo's transfer of those assets into a national bank.

A Historic New Alliance

I speak for other States in my enthusiastic and energetic support for section 1041 provisions of the Consumer Financial Protection Agency Act of 2009 that establish Federal law as a minimum standard for consumer protection, allowing States to enact laws and regulations "if the protection such statute, regulation, order, or interpretation affords consumers is greater than the protection provided under this title, as determined by the [Consumer Financial Protection] agency." In addition, the proposal amends various Federal preemption statutes to unshackle the States, allowing enactment of consumer protections at the State level that may become a model for Federal, nationwide standards.

This law exemplifies federalism at its best—State and Federal authorities working in common rather than conflict, and making the States laboratories for new, creative measures. Many of our most prominent Federal consumer protection laws were first adopted by States.

A Federal Consumer Financial Super Cop

I also support the establishment of the Consumer Financial Protection Agency, a Federal office dedicated solely to protection of ordinary citizens using the Federal savings and payment market.

Currently, consumer credit products are regulated by at least seven different agencies whose primary focus is the proper operation of markets and the safety and soundness of institutions. While consumer protection is within their jurisdiction, it is far from their major focus. Nor does any existing agency dedicate significant or sufficient resources to this responsibility.

They pay scant attention to consumer complaints, often reviewing such problems from an industry perspective rather than the consumer's. Indeed, these agencies face divided loyalties or even conflicts of interest—when high interest rates and astronomical credit card fees, for example, may be good for the bottom line, but bad for consumers. Given the understandable emphasis on safety and soundness, consumer protection not surprisingly receives Short shrift.

The Consumer Financial Protection Agency would have broad authority to promulgate and enforce rules to protect consumers from unfair and deceptive practices and to ensure they understand terms and conditions. These regulations will encourage, not stifle, the development of financial products that well serve consumers. A vibrant, competitive market that is fair and honest is essential to consumers' and the Financial Industry's financial interests. Clear rules and consistent enforcement are vital prerequisites for innovation and wealth creation. To mix metaphors, what's needed is a more level playing field—essentially rational rules of the roads. When intersections become busy, they need to upgrade from stop signs to traffic lights to avoid car crashes, collisions and pile ups. As the proposal recognizes, joint proactive consumer protection enforcement by both Federal and State agencies—without preemption or exclusive jurisdiction—best serves consumer interests, especially as financial products and markets grow in complexity and number.

State agencies—including State attorneys general and other consumer protection agencies—are often the first line of defense for consumers. Consumers are usually far more comfortable contacting their State officials rather than nameless faraway Federal agencies. I have seen firsthand the frustration of consumers when we have had to tell them that my office is legally powerless to help because of Federal preemption of State enforcement authority.

Under the proposal, States may enact and enforce consumer protection laws that are consistent with Federal law. In addition, State attorneys general may enforce Federal rules and regulations in this area provided that the Federal Consumer Financial Protection Agency is notified of such enforcement action and has the opportunity to join or assume responsibility.

This notification process seeks Federal–State coordination without necessarily allocating primacy to the Federal agency. State Attorneys General welcome the Federal Government as an ally rather than an adversary. Joint efforts can involve far more effective and more efficient use of our resources.

Joint State and Federal enforcement efforts are neither new nor novel. States regularly work with each other and the Federal Government in recovering hundreds of millions of dollars in Medicaid and health care fraud, enforcing our respective antitrust laws against anticompetitive mergers and acquisitions or abuse of market

power, and applying consumer protections laws against deceptive or misleading advertisements. I served for several years as chair of the National Association of Attorneys General Antitrust Executive Committee which included regular meetings with the heads of the Department of Justice Antitrust Division and the Federal Trade Commission. Successful collaborations once were common—against Microsoft for example—especially when the Federal Government was an active antitrust enforcer. There are plenty of successful models of joint action involving, for example, the Federal Trade Commission and the United States Department of Justice's Antitrust Division.

Separating regulatory authority from consumer protection authority also has models at the State level. In Connecticut, for example, the Department of Banking regulates the banking industry while the Department of Consumer Protection through the Office of the Attorney General has broad consumer fraud enforcement authority. That authority extends to the banking industry. The Connecticut Supreme Court specifically applied our unfair and deceptive trade practices act to the banking industry. *Mead v. Burns,* 199 Conn. 651 (1986).

I appreciate the industry's concern about two sets of agencies with enforcement authority. The industry justifiably wants predictability of regulation to properly plan product development and promotion. This bill will do so by creating a regulatory floor that applies nationwide. Most valuable would be predictability of vigilant and vigorous enforcement. The message must be that a revived and reinvigorated Federal–State alliance will punish any company that profits from illegal anticonsumer devices or unfair and deceptive practices. The predictable outcome is that anyone who cons or scams consumers in financial products will be prosecuted.

Part of the genius of our Federal system is that it creates separate distinct sets of authority in Federal and State governments. Individual State experiments in solving problems and lawmaking can be models for Federal statutes as well as other States. Our United States Constitution assures that States cannot adopt rules inconsistent or conflicting with Federal authority.

Finally, I urge the Committee to consider authorizing private rights of action against consumer fraud. Most State consumer protection statutes permit such private legal actions enabling victims to bring legal actions and recover damages, sometimes when State authorities may not do so. These initiatives supplement and strengthen State consumer protection enforcement efforts. They could similarly enhance and enlarge Federal enforcement efforts.

I appreciate and applaud your and the Administration's dedication to protecting consumers in financial transactions. I commend this Committee's support of these efforts and offer my continuing assistance—along with other State attorneys general.

Thank you.

PREPARED STATEMENT OF EDWARD L. YINGLING

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
AMERICAN BANKERS ASSOCIATION

JULY 14, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, my name is Edward L. Yingling. I am President and CEO of the American Bankers Association (ABA). The ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the Nation's banking industry and strengthen America's economy and communities. Its members—the majority of which are banks with less than $125 million in assets—represent over 95 percent of the industry's $13.5 trillion in assets and employ over 2 million men and women.

ABA appreciates how this Committee has responded to the financial crisis in a thoughtful, deliberative, and thorough manner. Changes are certainly needed, but the pros and cons and unintended consequences must be carefully evaluated before dramatic changes—affecting the entire structure of financial regulation—are enacted. That is why hearings like this one today are so important.

I am pleased to present the ABA's views today on the proposal to create a new consumer regulatory body for financial services that would operate separate and apart from any future prudential regulatory structure. We believe that a separate consumer regulator should not be enacted, and, in fact, is in direct contradiction with an integrated, comprehensive approach that recognizes the reality that consumer protection and safety and soundness are inextricably bound. Consumer pro-

tection is not just about the financial product, it is also about the financial integrity of the company offering the product. Simply put, it is a mistake to separate the regulation of the banking business from the regulation of banking products.

Financial integrity is at the core of good customer service. Banks can only operate safely and soundly if they are treating customers well. Banks are in the relationship business, and have an expectation to serve the same customers for years to come. In fact, 73 percent of banks (6,013) have been in existence for more than a quarter-century, 62 percent (5,090) more than half-century, and 31 percent (2,557) for more than a century. These banks could not have been successful for so many years if they did not pay close attention to how they serve customers. Satisfied customers are the cornerstone of the successful bank franchise. The proposal for a new consumer regulator, rather than rewarding the good banks that had nothing to do with the current problems, will add an extensive layer of new regulation that will take resources that could be devoted to serving consumers and make it more difficult for small community banks to compete.

The banking industry fully supports effective consumer protection. We believe that Americans are best served by a financially sound banking industry that safeguards customer deposits, lends those deposits responsibly and processes payments efficiently. Traditional FDIC-insured banks—more than any other financial institution class—are dedicated to delivering consumer financial services right the first time and have the compliance programs and top-down culture to prove it. Certainly, there were deficiencies under the existing regulatory structure. Creating a new consumer regulatory agency, however, is not the solution to these problems. It would simply complicate our existing financial regulatory structure by adding another extensive layer of regulation. There is no shortage of laws designed to protect consumers. Making improvements to enhance consumer protection under the existing legal and regulatory structures—particularly aimed at filling the gaps of regulation and supervision of nonbank financial providers—is likely to be more successful, more quickly, than a separate consumer regulator.

Certainly the Members of this Committee should look at this consumer agency proposal from the point of view of consumers, who are paramount. Later in this testimony, we will discuss how the proposal in our opinion is not the best approach for consumers and will actually undermine consumer choice, competition, and the availability of credit. However, we would also ask you to look at this issue from another point of view. While all banks would be negatively impacted, think of your local community banks, and credit unions also for that matter. These banks never made one subprime loan, and they have the trust and support of their local consumers. As Members of this Committee have previously noted, these community bankers are already overwhelmed with regulatory costs that are slowly but surely strangling them.

Yet a few weeks ago, these community banks found the Administration proposing a potentially massive new regulatory burden that will fall disproportionately on them. The largest banks, which will certainly bear a significant burden as well, do have economies of scale. Nonbanks, the State regulated or unregulated financial entities that include those who are most responsible for the crisis, are covered, at least in part, by the new agency—and that is positive. However, based on history, their regulatory and enforcement burden is likely to be much less. In fact, according to the Administration proposal, the new agency will rely first on State regulation and enforcement for these entities, and yet we all know that the budgets for such State regulation and enforcement are completely inadequate to do the job. Community banks, on the other hand, are likely to have greatly increased fees to fund a system that falls disproportionately and unfairly on them.

In both the Administration's white paper and the legislative language submitted by Treasury, it is now clear that the new agency would have vast and unprecedented authority to regulate in detail all bank consumer products and services. The agency is even empowered, in fact encouraged, to create its own standardized products and services—whatever it decides is "plain vanilla"—and may compel banks to offer them. Even further, the agency is given the power, and basically urged, to give the products and services it designs regulatory preference over the bank's own products and services. The agency is even encouraged to require a Statement by the consumer acknowledging that the consumer affirmatively was offered and turned down the Government's product first.

The proposal goes beyond simplifying disclosures—which is needed—to require that all bank communication with consumers be "reasonable." This is a term so vague that no banker would know what to do with it. But not to worry—the proposal offers to allow thousands of banks, and thousands of nonbanks, to preclear all communications with the agency.

All existing consumer laws, carefully crafted over the years by Congress, are transferred to the new agency, but they are rendered nothing more than floors. The new agency can do almost anything else it wants. CRA enforcement is apparently to be increased on these community banks, although they already strongly serve their communities. And that is not to mention the inherent conflicts, discussed below, that will occur between the prudential regulator and the consumer regulator, with the bank caught in the middle. All this cost, regulation, conflicting requirements, and uncertainty would be placed on community banks that in no way contributed to the financial crisis.

We share the vision that greater transparency, simplicity, accountability, fairness, and access can be achieved by establishing common standards uniformly applied that reflect how consumers make their choices among innovative products and services. But this vision cannot be achieved by ignoring the experience of our recent financial crisis and failing to directly address those deficiencies that led to it. It is now widely understood that the current economic situation originated primarily in the unregulated or less regulated nonbank sector. For example, the Treasury's plan noted that 94 percent of high cost mortgages were made outside the traditional banking system. Many of these nonbank providers had no interest in building a long-term relationship with customers but, rather, were only interested in profiting from a quick transaction without regard to whether the mortgage loan or other financial product ultimately performed as promised. Thus, an important lesson learned is that certain unsupervised nonbank financial service providers and their less regulated financiers—the so-called "shadow banking system"—undermined the entire system by abusing consumer and investor trust.

A second lesson learned is that consumer protection and financial system safety and soundness are two sides of the same coin. Poor underwriting, and in some cases fraudulent underwriting, by mortgage brokers, which failed to consider the individual's ability to repay, set in motion an avalanche of loans that were destined to default. Good underwriting is the essence of both good consumer protection and good safety and soundness regulation. Loans that are based on the ability to repay protect the institution from losses on the loans and protect consumers from taking on more than they can handle. Thus, what is likely to protect both the lender and the customer cannot be, nor should be, separated.

These lessons lead to two fundamental building blocks of any reform of consumer protection oversight.

- Uniform regulation and uniform supervision of consumer protection performance should be applied to nonbanks as rigorously as it has been applied to the banking industry.
- Regulatory policymakers for consumer protection should not be divorced from responsibility for financial institution safety and soundness.

Separating the safety of the institution from the safety of its products means each agency has only half the story. Without building upon these keystones, the hope for better transparency, simplicity, accountability, fairness, and access will not be realized, and we will have missed the opportunity to build a strong consumer protection infrastructure across the financial services industry.

Unfortunately, the Consumer Financial Products Agency (CFPA) proposal, in our opinion, contains a number of very serious flaws. The proposal:

- Severs the connection between consumer protection and safety and soundness—forcing each side to attempt to work independently and freeing each to contradict the valid goals of the other—to the detriment of consumer choice and safety and soundness.
- Subjects banks to added enforcement, but leaves the "first line of defense" for the supervision and examination of nonbanks to the States, which suffer from a lack of resources for meaningful enforcement. This is where the failure of nonbank regulation was most severe under the current system. Once again there would be perverse incentives for financial products to flow out of the closely examined banking sector to those who will skirt the meaning, and even the language, of regulations.
- Excludes competitor financial products from its reach—including securities, money market funds, and insurance—thus further belying the promise of uniform or systemic oversight and creating incentives for development of products outside the scope of the CFPA that may be risky for consumers.
- Renders all the consumer laws created by Congress largely moot, as the very broad power of the CFPA would authorize the agency to go well beyond such laws in every instance.

- Imposes Government designed one-size-fits-all products—so-called "plain-vanilla" products—and places them in a preferred position over products that are designed by the private sector for an increasingly diverse customer base. These Government products would be given regulatory preference over the products designed by the individual banks, and consumers could even be required to sign a notice that they have first turned down the Government's product.
- Requires communications with consumers to be "reasonable," an incredibly vague and unworkable standard that will cause tremendous uncertainty for years to come.
- Basically ends uniform national standards, quickly creating a patchwork of expensive and contradictory rules that will create uncertainty, increase consumer costs, and lead to constant litigation.
- Saddles providers, and, indirectly, consumers with a new regime of fees to fund yet another agency.
- Will inhibit innovation and competition, limit consumer choices, and lessen the availability of credit.

To be successful in the regulation, examination, and enforcement of nonbanks, the agency will have to be very large and have a significant budget. We believe a better course exists. ABA offers to work with the Administration and the Congress to achieve meaningful regulatory reform to improve consumer protection and preserve financial system integrity. As the crisis has proven, a strong banking industry is indispensable to a strong economy; and a sound banking system is the greatest single protection of consumer access to financial services fairly delivered. Traditional banking is back in style, but that does not mean improvements cannot be made. We pledge to work with this Committee to find the best solutions to assure that consumers have the protection they deserve for any financial product.

I would like to further discuss several points today:

- Consumer regulation should not be separated from safety and soundness regulation.
- The key focus of change should be on closing existing gaps in supervisory oversight across the financial institution marketplace, not on adding yet another vast layer.
- The proposal would give the agency unprecedented authority to control the products and services offered by banks and make all current consumer laws mere floors.
- The undermining of uniform national standards will increase costs and cause litigation and tremendous uncertainty.
- The question of how to pay for this new agency was left very vague and raises significant issues.
- The proposal will inhibit innovation and competition, limit consumer choices, and dramatically lessen the availability of credit.
- The regulatory authority to address consumer concerns is already there for highly regulated banks, particularly with the new focus on unfair and deceptive practices. However, improvements can be made, and ABA will work with the Committee to make such improvements.

I will address each of these points in turn.

Consumer Regulation Should Not Be Separated From Safety and Soundness Regulation

Consumer regulation and safety and soundness regulation are two sides of the same coin. Neither one can be separated from the other without negative consequences; nor should they be separated. An integrated and comprehensive regulatory approach is the best method to protect consumers and protect the safety and soundness of the financial institution. While certainly improvements can be made, the current regulatory structure applied to banks provides an appropriate framework for effective regulation for both consumer protection and bank safety and soundness. As I note throughout this testimony, that same framework was virtually nonexistent for nonbank providers of financial products.

FDIC Chairman Sheila Bair, testifying recently before Congress, summarized the synergies between both these elements:

> The current bank regulation and supervision structure allows the banking agencies to take a comprehensive view of financial institutions from both a consumer protection and safety and soundness perspective. Banking agencies' assessments of risks to consumers are closely linked with and informed

> by a broader understanding of other risks in financial institutions. Conversely, assessments of other risks, including safety and soundness, benefit from knowledge of basic principles, trends, and emerging issues related to consumer protection. Separating consumer protection regulation and supervision into different organizations would reduce information that is necessary for both entities to effectively perform their functions. Separating consumer protection from safety and soundness would result in similar problems.[1]

Attempts to separate out consumer protection from safety and soundness will lead to conflicts, duplication and inconsistent rules, which will likely result in finger-pointing as inevitable problems arise. What are banks to do when the consumer and safety and soundness regulators disagree, as they inevitably will?

Almost every consumer bank product or service has both consumer issues and safety and soundness issues that need to be balanced and resolved. It is important to remember that one person's deposit funds another person's loan. It makes little sense to regulate the terms, conditions and prices of deposit products or loan products separately from the business aspects of a bank's fundamental process—turning deposits into loans.

As I mentioned at the outset, the very nature and application of good underwriting standards is by definition both a consumer protection and a safety and soundness issue. A second simple example is check hold periods. Customers would like the shortest possible holds, but this desire needs to be balanced with complex operational issues in check clearing, and with the threat of fraud, which costs banks—and ultimately consumers in the form of increased costs that are passed on—billions of dollars.

Similarly, the Electronic Funds Transfer Act contains numerous important consumer protections, developed and modified over the years based on experience, new technologies, and new types of fraud. Separating the consumer consideration from the safety and soundness, antifraud, and systems considerations would certainly seem unworkable.

Banks also have extensive duties under "know your customer" regulations designed to fight money laundering and terrorism. These critical regulations must be coordinated with consumer and safety and soundness regulation. A simple example is in the account opening process, which is subject to extensive consumer and "know your customer" regulations. It would be unworkable to separate these as well.

And what about employee training? Banks spend billions of dollars training employees to comply with the heavy regulations to which banks are subjected. Examiners examine banks for their training programs. Front-line employees must have training in numerous consumer, safety and soundness, and antimoney laundering regulations. ABA offers dozens of courses in compliance for front-line employees. How would such training be effectively coordinated between agencies with differing views and objectives? Is the new agency going to examine banks and nonbanks equally for compliance training? It cannot be left to the States, where there is little precedent for extensive examining for compliance training outside banking.

Rather than take to heart the lesson of the inseparability of safety and soundness and consumer protection, the Administration's proposal creates a different form of regulatory fragmentation along the fault lines of the jurisdiction of a new bureaucracy. A look at the proposal's enumeration of existing rule-making authorities to be transferred—mostly from the Federal Reserve Board—to the CFPA reveals an assortment of likely interagency conflicts that will generate future regulatory gaps rather than bridge the current ones.

For instance, consumer privacy is placed in the CFPA, but identity theft protection is left out. The Electronic Funds Transfer Act is assigned to CFPA, but the rules for clearing electronic check images that make funds available for customers to access with their debit cards remains with the Federal Reserve. Truth in Lending Act rule-making over mortgages is assigned to the CFPA, but flood insurance coverage (FDPA) and private mortgage insurance (HOPA) laws protecting consumers who obtain mortgages remain with the banking agencies. These and other anomalies in the Administration proposal will set true consumer protection reform on the back-burner as countless hours and dollars are wasted grappling with the regulatory morass that will result from this ill-advised structural reform. The 30-year investment in coordinated supervision (FFIEC) will be washed away and replaced by interagency conflicts that are hardwired in the new bureaucracy without a means to resolve them.

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[1] Bair, Sheila C., "Modernizing Bank Supervision and Regulation", testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 19, 2009.

Finally, we are very concerned about conflicts over CRA. The banking industry has worked hard in serving its communities and in complying with CRA. We agree that CRA has not led to material safety and soundness concerns, and that bank CRA lending was prudent and safe for consumers. That is not to say that there is no debate about the correct balance between outreach and sound lending. However, that debate—that tension—is resolved now in a straightforward manner because the same agency is in charge of CRA and safety and soundness. To separate the two is a recipe for conflicting regulatory demands, with the bank caught in the middle.

In the above examples and in many other areas, two different regulators—one focused on consumers and another focused on safety and soundness—will almost certainly come up with two different and conflicting rules and answers that, when added together, only create new costs, overlap and duplication, as well as an untenable situation for the financial institution.

The Key Focus of Change Should Be on Closing Existing Gaps in Regulation, Not on Adding Yet Another Bureaucratic Layer

The biggest failures of the current regulatory system, including consumer protection failures, have not been in the regulated banking system, but in the unregulated or weakly regulated sectors.[2] As Members of Congress from both parties have noted, to the extent that the system did work, it is because of prudential regulation and oversight of banking firms. While improvements within the banking regulatory process can certainly be made, the most pressing need is to close the regulatory gaps outside the banking industry through better supervision and regulation—both on the consumer protection and safety and soundness sides of the coin.

Take the case of independent mortgage brokers and other nonbank originators. Again, as the Administration's own proposal States, 94 percent of the high cost mortgages occurred outside the regulated banking sector. And it is likely that an even higher percent of the most abusive loans were made outside our sector. In contrast to banks, these nonbank firms operate in a much less regulated environment, generally without regulatory examination of their conduct, without strong capital provisions, and with different reputational concerns. They have not been subjected to the breadth of consumer protection laws and regulations with which banks must comply. Equally important, a supervisory system does not exist to examine them for compliance even with the comparatively few laws that do apply to them. In addition, independent brokers typically do not have long-term business relationships with their customers. Instead, they originate a loan, sell the loan to a third party, and collect a fee. This results in a very different set of incentives and can and does work at cross-purposes with safe and sound lending practices. Proposals are also being offered with respect to credit derivatives, hedge funds, and others, and the ABA supports closing these regulatory gaps.

In stark contrast to the weakness of oversight or examination of consumer compliance issues for most other financial service providers, bank regulators have an extraordinarily broad array of tools at their disposal to assure both consumer protection and safety and soundness. Banks are regularly examined for compliance with consumer regulations, and regulators devote significant resources to supervision and training in consumer compliance issues.[3] These enforcement and supervisory options are coordinated through the Federal Financial Institutions Examination Council (FFIEC),[4] which sets standards for both consumer and safety and soundness ex-

[2] Before the recent crisis, a coalition of 46 State Attorneys General recognized that based on consumer complaints received, as well as investigations and enforcement actions undertaken by them, predatory lending abuses were largely confined to the subprime mortgage lending market and to nondepository institutions. Almost all of the leading subprime lenders were mortgage companies and finance companies, not banks or direct bank subsidiaries. We stress the past tense, because their lack of financial robustness assured that they would not be around to answer for their consumer protection misdeeds.

[3] Bank regulators are just as concerned about consumer protection as are law enforcement authorities, but the bank regulators are better able to achieve their objectives through an enormous array of enforcement and supervisory options that allow them to meet their broader mandate for law enforcement as well as financial stability. These range from the behind-the-scenes citation in an exam report as a matter requiring attention to the public actions of issuing a cease-and-desist or civil money penalty order or even closing a bank and imposing lifetime bans from participating in banking activities. Bank examiners can direct a bank to stop taking an action or to take some different action. These tools are most appropriately and effectively exercised by one regulator that is focused on achieving the balance described above.

[4] The FFIEC, represented by the Federal Reserve, OCC, FDIC, OTS, and NCUA, is charged with prescribing "uniform principles and standards for the Federal examination of financial institutions" designed to "promote consistency in such examination and to insure progressive and vigilant supervision."

amination.[5] The need is for the same banklike structure, supervision, and examination to be applied to nonbank financial service providers.

There obviously have been consumer concerns with respect to banks—we certainly know of this Committee's concerns with credit card practices—but if the great majority of abuses occurred outside the banking industry (with toxic subprime mortgages, for example), why would Congress create a new regulatory agency that will end up focusing its resources predominately on banks and not nonbanks? We see that the intention is to have regulations that cover most providers. However, regulation without enforcement can be worse than no regulation in that it gives rogue institutions a veneer of legitimacy. All evidence tells us that the States will not have the resources to enforce all these regulations. We have, frankly, little confidence that the CFPA will apply equal examination and enforcement on nonbank lenders and others, or that it will have the resources to do so. This concern is exacerbated by the incredibly vague funding provisions in the legislative language. How big is this agency to be? If it is not large, it cannot conceivably enforce its regulations on the thousands of institutions it is supposed to regulate. If it is big, how is it to be paid for?

The Proposal Gives the CFPA Unprecedented Authority To Control the Products and Services Offered by Banks

As Stated earlier, the proposal calls for an unprecedented delegation of legislative authority to the agency to control the way consumer products and services are designed, developed, marketed, delivered, and priced by banks and other financial service providers. In fact, the agency is encouraged to design products and services, mandate that banks offer them, regulate the products not designed by the agency more heavily than the Government product, and require consumers to sign a document that they do not want the Government-designed product. The agency can even heavily regulate compensation systems under very open-ended authority. All communications to consumers about products and services would have to be "reasonable," a vague and unworkable standard if there ever was one. This would appear to give the agency an incredible amount of control over banks' and others' products without any real legislated standards. Simply put, this would appear to be the most powerful agency ever created in that it has almost unlimited power to regulate and even mandate the products offered by the regulated.

It also would very much undermine incentives for innovation and better customer choice. Certainly banks and nonbanks would be less likely to create new products or consumer enhancements. Any deviations from the Government-designed product would be subject to additional regulation and clearances. Coupled with the prohibition that it is unlawful "to advertise, market, offer, [or] sell . . . a financial product or service that is not in conformity with the [Act]," the Administration's proposed new structure places banks and nonbanks alike at extreme risk when innovating and will chill efforts to respond to consumer demand for beneficial products and services.

Proponents of the agency have regularly used the catch-phrase that we regulate toasters to keep them from blowing up (through the Consumer Product Safety Commission), but we don't regulate mortgages that can blow up consumers' finances. There are a number of problems with this analogy, including that mortgages are regulated and that, unlike a toaster with electrical problems, a financial product may often be a problem or not depending on to whom and how it is offered. More fundamentally, unlike the proposed CFPA, the Consumer Product Safety Commission is not set up to design a toaster; mandate that anyone selling toasters offer the Government toaster; and furthermore, to adjust regulation, disclosures, and liability to put the Government toaster in a preferred position. Of course such a Government toaster could not meet the multitude of preferences of single people on the

[5] In addition, the FFIEC agencies have set forth common standards for determining a bank's rating for consumer compliance performance. This rating stands as an identifiable grade, separate and apart from the CAMEL rating, so that boards of directors and regulators can hold management directly accountable for the quality of their institution's consumer compliance management programs and performance. Moreover, the FFIEC's agency members have endorsed top-down consumer compliance programs expected of banks that contain system controls, monitoring of performance, self-evaluation, accountability to senior management and the board, self-correcting processes, and staff training.

The breadth of this supervisory authority is extensive. Consumer compliance management plays a role in every operational aspect where a bank comes into contact with customers—from the marketing of products, through account opening and credit Administration, to handling personal information and monitoring for financial crime. Further, banks hold their employees accountable for meeting their obligations. Every bank invests heavily in consumer compliance with dedicated compliance professionals who take great pride and apply tremendous effort to assure that consumers are being treated fairly.

run, small families, large families, those with small kitchens, those with large kitchens, those that just want toast, those that just want toast and English muffins, and those that want a multifunctional toaster oven, *etc.* And, of course, such a Government plain-vanilla toaster with such built in advantages would discourage innovation in the creation of new options for consumers and competition in the offering of alternatives.

In many cases, the Government financial product might not fit with the institution's business plan. Niche banks, which serve important constituencies, such as small business owners or low income communities, would be required to offer products that simply do not fit. There will even be safety and soundness issues. For example, some banks that maintain all their loans in portfolios do not, and should not, hold 30-year fixed "plain-vanilla" mortgages.

Furthermore, the incredible authority given to the proposed agency means that all the consumer laws enacted and modified by Congress over the years, which have resulted in hundreds and hundreds of pages of regulations, are to a large degree moot. They are mere floors; and, in fact, floors with holes in them. This new agency can do pretty much anything it wants in any of the areas specifically covered by the laws, and any other area relating to consumer financial products for that matter. In the final analysis, the basic premise of the Administration's proposal is to invite Congress to abdicate its legislative responsibilities to address the ever-evolving financial marketplace and delegate plenary discretion to a seemingly all-knowing and all-powerful agency.

For example, this Congress just passed an extensive, tough new law on credit cards. Combined with the previous law, this creates a comprehensive congressionally crafted set of rules governing cards. Yet the proposed CFPA legislation would grant the agency authority to do practically anything it wants in the credit card area with respect to terms, delivery, disclosures, compensation and even mandated products, as long as it does not do less than the new card law. One wonders why Congress undertook such extensive reform of the credit card law if it was going to give almost open-ended authority to the CFPA shortly thereafter.

The Undermining of National Standards Will Increase Costs and Cause Tremendous Litigation and Uncertainty

The Commerce Clause of the Constitution was designed to allow products and services to flow freely across State lines. It is hard to think of an area of our economy where this should be encouraged more than in financial services, where the market for products from loans to deposits is national in scope. With changes in technology—such as the Internet—and the incredible mobility of our society, the free flow of financial services is even more pronounced. Furthermore, the National Bank Act, enacted during the Civil War, was created to provide for a national bank system that would not be subject, in its basic bank functions, to State laws. This national banking system, as part of the dual banking system, has served us well. However, a national system cannot function effectively if all national bank consumer products are subject to 50 different State laws. As we have noted, the safety and soundness regulator will not be able to do its job if it has no authority over consumer laws, much less if that authority is held by not only the Federal consumer regulator, but every State regulator, legislature, and attorney general as well.

The multitude of rules—and do not underestimate how incredibly complex they would be—would subject banks to tremendous legal costs in order to comply, and also to deal with constant litigation. Every product, form, and customer communication would have to be checked and rechecked regularly for compliance with changing laws in all 50 States. Customers will move to other States regularly, and the bank would have to assume its customers could be in any State.

There are many areas where problems will arise. ATM cards could be subject to different rules by State, resulting in their not being useable in every State at great inconvenience to travelers, who could be left stranded without funds. Online banking could be affected as differing rules would apply, depending on where the customer is located.

Costs to consumers would increase as banks try to address all the different rules. Innovation would be discouraged as any changes would have to be tested against all the different State rules. The European Union is working to develop common rules in order to have greater efficiencies and innovation, and yet the Administration's proposal would go in exactly the opposite direction—toward balkanization. From a consumer's standpoint, such regulatory complexity will be translated to account or loan agreement legalese to rightfully protect the bank from elaborate and conflicting requirements—all to the detriment of simplifying consumer products and making transactions more transparent. Proponents of the proposal talk about providing one page of simple disclosures—a goal much to be sought; but how can such

a goal be achieved if there would have to be page after page of disclosures to cover all the State law differences?

The Question of How To Pay for This New Agency Was Left Very Vague and Raises Significant Issues

To discharge its powers consistently over both banks and nonbanks, this new agency will have to be extraordinarily large. It will need to regulate, and in many cases examine, not just banks and credit unions, but finance companies, payday lenders, mortgage brokers, mortgage bankers, appraisers, title insurers and many others—apparently even pawn shops.

However, under the proposal, no one has any idea how large this agency is to be. If it is small, its focus will inevitably be on the already regulated banks, even though, as already noted, 94 percent of the high cost mortgages came from outside banks. That would be incredibly unfair and counterproductive. To do its job as advertised by proponents, this agency would need to ensure that the thousands of nonbanks under its jurisdiction are reporting, examined, and subject to enforcement in the same way banks will be. While the States are supposed to be a front line of defense, it is not credible to argue that States will have the budgets to implement such reporting, examination, and enforcement even to a minimal degree. Therefore, the new agency will need to do it, or its whole rationale falls apart.

Where is this agency's budget to come from? Apparently, the budget is to be based on fees on financial service products. The Consumer Products Safety Commission, said to be the model for the CFPA, is not funded by toy or appliance manufacturers, but rather by an appropriation. However, if the CFPA is to accomplish its goals and to effectively regulate nonbanks, it would need to be considerably bigger than the Consumer Products Safety Commission. Banks are already heavily burdened with funding their regulators, directly and indirectly (*e.g.,* deposit insurance premiums fund the FDIC's regulatory costs). These costs cannot simply be split apart to pay for the banks' part of the consumer regulator, as the tremendous efficiencies that result from combining safety and soundness and consumer regulation will be lost.

How is the agency to collect fees from nonbank providers? On what basis? How is it going to know about new entrants, unless they are required to register with the agency? As new types of providers spring up, how are they to be incorporated? There will, in fact, have to be a large bureaucracy just to collect the fees. Of course, these new costs, basic economics tells us, will ultimately be passed on to the users of the products, and so consumers will end up paying for this large new agency.

Obviously, these are very difficult questions that were not addressed in the Administration's proposal, but which should be answered before proceeding. Given the incredibly broad authority and ambitions of the proposal, it is impossible for Congress to judge what it will, in fact, do without knowing the size it is going to be.

The Proposal Will Inhibit Innovation and Competition, Limit Consumer Choices, and Dramatically Lessen the Availability of Credit

The proposal will, first, create tremendous uncertainty in the financial community about what the rules will soon be. The entire body of rules that has governed the development, design, sales, marketing, and disclosure of all financial products would be subject to change, and be expected to change dramatically in many instances. When developing and offering products, firms rely on the basic rules of the road, knowing that they are subject to careful changes from time-to-time. Now there would be no certainty. This lack of certainty will cause firms to pull back from developing new products and new delivery systems. And it will chill lending, as firms will not know what the rules may be when they try to collect the loan a few years out.

This problem should not be underestimated. Why design a new product if you do not know what regulatory rules will be applied to it? Why stretch to make a loan to a deserving consumer when it may be determined after the fact that your stretch terms and disclosures were unreasonable and the contract is therefore unenforceable. Everyone will be on hold, to some degree, waiting for the development, which will take years of regulatory action and judicial interpretation, of an entirely new roadmap.

What makes this situation particularly difficult is that the proposed legislation, and the narrative provided with it, contains vague terminology that has little or no legal history. What on earth does "reasonable" mean for disclosures and communications? The legal concept of "unfair and deceptive," developed over many years, is also changed. It will take years for these new legal concepts to be defined fully by the courts. In the meantime, lenders will have no idea what their potential legal rights and liabilities will be.

Second, you have the huge cost for legal and other work for redoing the basis on which products are offered today. The current design of many products and disclosures is thrown into question by the concepts of this proposal. This is a cost that, again, will ultimately be borne in large part by consumers.

For example, credit card companies are in the process of spending hundreds of millions of dollars to change their systems, their disclosures, their risk models, and basic parts of the product to meet the new regulations and law. If this proposal is enacted, given the testimony of Treasury, it seems quite likely that additional significant changes will be made in regulations. How is the financial industry to plan for such uncertainty?

Third, the regime surrounding Government designed products will undermine innovation and the availability of credit. As noted previously, the Government designed products, given regulatory advantages, will undermine the incentive to develop new products. If an institution develops an idea that could enhance the basic product for all consumers or a subset of consumers, adding it will cause the product to no longer be "Government approved" and will subject it to discriminatory regulation and legal uncertainty. Why bother? Ideas that could give consumers benefits or lower costs will never see the light of day.

The impact on lending will be profound. First, loan adjustments, which are made constantly in today's world, to fit a borrower's needs or allow the loan to be made simply will not happen. Those most hurt will be lower income consumers. Furthermore, the very large uncertainty and potential legal liabilities will cause less credit to be available, at the very time when credit is already scarce. Our Government is in danger of designing policies that are absolutely contradictory—encouraging more credit to be available, while at the same time, through the President's proposal, designing a legal morass that will have a dramatic effect in lowering the availability of credit.

Improvements Can Be Made

ABA agrees that improvements can and should be made to protect consumers. The great majority of the problems occur outside the highly regulated traditional banks, but there are legitimate issues relating to banks as well. The ABA is committed to working with Congress to address these concerns and implement improvements. In that regard, let me outline some concepts that should be considered.

- *Enhance capabilities to apply unfair and deceptive practices:* As you know, the Federal Reserve Board and the OTS have long had a very powerful tool called unfair and deceptive practices or UDAP. This had not been used as a broad regulatory tool for banks prior to the extensive credit card rule. However, use of this authority would address many of the issues raised. The UDAP authority is already in place. The ABA supports legislation the House passed last year to extend this authority in a coordinated fashion to the OCC and FDIC. The FTC has this authority for nonbanks, but there have been severe constraints in using it. Congress should work to give the FTC the capability and funding to apply it to nonbanks much more aggressively.
- *Improve disclosure, using consumer testing:* Disclosures can and should be improved, although it will not be easy. Current disclosures are by-and-large driven by lawyers and the need to cover the many legal complexities involved to protect against the real threat of litigation. Congress, the regulators, the industry, and consumer advocates need to overcome this bias. Progress has been made through the insights gained from consumer testing. Simple disclosures, perhaps in combination with larger, separate ones required for legal purposes, should be made in ways that most benefit consumers. Concepts gleaned from behavioral science relating to how consumers really react should be included in disclosure design.
- *Enable basic products without stifling competition, innovation and consumer choice:* In some cases financial products have become overly complex and difficult, if not impossible, for consumers to understand. This is not unusual in our economy as many product offerings—from consumer electronics, to telephone plans, to insurance—have become very complex. Often this complexity results from efforts to add options that consumers may want. Sometimes, as we all know, the complexity induces consumers to buy products or enhancements that are not right for them or for which they pay too much. However, as discussed previously, ABA believes the answer is not to have the Government design products, mandate that they be offered, and give them an advantage over private sector products. Nevertheless, there is a need to have product options that are basic and easily compared, and to have, at the same time, a flexible, private-sector driven system that does not stifle competition and innovation. For

example, the private sector, perhaps through the ABA as the industry's trade association, could consult with the regulators, Congress, and consumer advocates to develop basic product forms that could be easily compared.

- *Develop centralized call centers for consumer complaints:* It is difficult, perhaps impossible, for many consumers to understand whom they should call in the Government to register concerns or complaints. ABA supports a centralized call center for consumers that could forward complaints to the right agency and serve as a coordinated information source.
- *Require regular reports to Congress:* The structure of consumer regulation within agencies can be reviewed and strengthened. Regular reports to Congress could be required.
- *Empower the systemic risk oversight regulator to look specifically at consumer issues that pose systemic concerns:* One clear lesson from the mortgage crisis is that consumer issues can raise systemic issues. If a systemic regulator had been in place, we would hope that it would have identified the rapid growth of subprime lending as a problem that had to be addressed well before it grew to such a hurricane force. The systemic regulator could be given the power to require regulatory agencies to address in a timely manner systemic consumer issues.

Conclusion

The ABA has very serious concerns about the proposed CFPA and the authorities it is to be given under the President's proposal. We believe it will result in a huge regulatory burden, particularly for community banks, while nonbanks, which are primarily responsible for the crisis, will have ineffective enforcement.

Healthy, well-regulated banks have already been hurt deeply by unscrupulous players and regulatory failures. They watched mortgage brokers and others make loans to consumers that a good banker just would not make. They watched local economies suffer when the housing bubble burst. Now they face the prospect of another burdensome layer of regulation. It is simply unfair to inflict another burden on these banks that had nothing to do with the problems that were created. The separate consumer regulator will only add costs to these banks, particularly community banks, which already suffer under the enormous regulatory burden placed on them. As you contemplate major changes in regulation—and change is needed—I urge you to ask this simple question: How will this change impact those thousands of banks that did not create the problem and are making the loans needed to get our economy moving again? Another question that should be asked is: How will this proposal really assure strong enforcement and examination of the nonbanks?

Furthermore, the proposal will dramatically undermine incentives to innovate and to offer new products from which consumers will benefit. Competition will be lessened, as the Government designed products limits avenues for competition. Finally, the availability of credit will be reduced, particularly in the short run, because of great uncertainty about the new, evolving rules and the increased legal liability.

As outlined above, we believe that separating safety and soundness regulation from consumer regulation would be a mistake. Nevertheless, there are important improvements that can and should be made in the consumer arena, and we will work with Members of this Committee to make such improvement in this arena, as well as on the many other important issues in regulatory reform.

PREPARED STATEMENT OF TRAVIS B. PLUNKETT

LEGISLATIVE DIRECTOR,
CONSUMER FEDERATION OF AMERICA

JULY 14, 2009

Summary

Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Travis Plunkett and I am the Legislative Director of the Consumer Federation of America (CFA).[1] I am pleased to be able to offer the views of

[1] The Consumer Federation of America is a nonprofit association of over 280 proconsumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

leading consumer, community, and civil rights groups[2] in support of the establishment of a Consumer Financial Protection Agency, as proposed first by Senators Durbin, Schumer, and Kennedy and most recently by President Obama. In addition to CFA, I am testifying on behalf of, Americans for Fairness in Lending,[3] Americans for Financial Reform,[4] A New Way Forward,[5] the Association of Community Organizations for Reform Now (ACORN),[6] Center for Responsible Lending,[7] Community Reinvestment Association of North Carolina,[8] Consumer Action,[9] Consumers Union,[10] Demos,[12] Florida PIRG,[13] The International Brotherhood of Teamsters,[14] National Association of Consumer Advocates,[15] National Community Reinvestment

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[2] The testimony was drafted by Travis Plunkett and Jean Ann Fox of the Consumer Federation of America, Gail Hillebrand of Consumers Union, Lauren Saunders of the National Consumer Law Center, and Ed Mierzwinski of U.S. PIRG.

[3] Americans for Fairness in Lending works to reform the lending industry to protect Americans' financial assets. AFFIL works with its national Partner organizations, local ally organizations, and individual members to advocate for reform of the lending industry.

[4] Americans for Financial Reform is a coalition of close to 200 national State and local organizations representing people from every walk of life, including homeowners, shareowners, workers, and low and moderate income community residents dedicated to making sure that the "main street" voice is heard in the debate on financial regulatory reform.

[5] A New Way Forward is a movement of citizens, started in March 2009. It harnesses the voice of citizens to stop the excessive and dangerous partnership between Government and the largest institutions of the financial sector in order to reinvigorate the public sphere. ANWF organizers are letting the world know that the way Congress is handling the financial crisis rewards the wrong people, is likely to fail, and doesn't get at the core structural problems in our economy. ANWF helped organize 60 protests ad 25 educational forums in the past 4 months.

[6] ACORN, the Association of Community Organizations for Reform Now, is the Nation's largest community organization of low- and moderate-income families, working together for social justice and stronger communities.

[7] The Center for Responsible Lending (CRL) is a not-for-profit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, which consists of a credit union and a nonprofit loan fund focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to purchase homes. Self-Help has provided over $5 billion in financing to more than 60,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the United States. Another affiliate, Self-Help Credit Union, offers a full range of retail products, and services over 3,500 checking accounts and approximately 20,000 other deposit accounts, and recently inaugurated a credit card program.

[8] The Community Reinvestment Association of North Carolina's mission is to promote and protect community wealth through advocacy, research, financial literacy and community development.

[9] Consumer Action is a national nonprofit education and advocacy organization serving more than 9,000 community based organizations with training, educational modules, and multilingual consumer publications since 1971. Consumer Action's advocacy work centers on credit, banking, and housing issues.

[10] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports,* its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with more than 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[12] Demos is a New York City-based nonpartisan public policy research and advocacy organization founded in 2000. A multi-issue national organization, Demos combines research, policy development, and advocacy to influence public debates and catalyze change.

[13] Florida PIRG takes on powerful interests on behalf of Florida's citizens, working to win concrete results for our health and our well-being. With a strong network of researchers, advocates, organizers and students across the State, we stand up to powerful special interests on issues to stop identity theft, fight political corruption, provide safe and affordable prescription drugs, and strengthen voting rights.

[14] The Teamsters union represents more than 1.4 million workers in North America. Teamsters work from ports to airlines, from road to rail, from food processing to waste and recycling, from manufacturing to public services. The Union fights to improve the lives of workers, their families and their communities across the global supply chain.

[15] The National Association of Consumer Advocates, Inc., is a nonprofit 501(c)(3) organization founded in 1994. NACA's mission is to provide legal assistance and education to victims of consumer abuse. NACA, through educational programs and outreach initiatives protects consumers, particularly low income consumers, from fraudulent, abusive and predatory business practices. NACA also trains and mentors a national network of over 1400 attorneys in representing consumers' rights.

Coalition,[16] National Consumer Law Center (on behalf of its low-income clients),[17] National Consumers League,[18] National Fair Housing Alliance,[19] Neighborhood Economic Development Advocacy Project,[21] Public Citizen,[22] Sargent Shriver National Center on Poverty Law,[23] Service Employees International Union,[24] USAction,[25] and U.S. PIRG.[26]

In this testimony, we outline the case for establishment of a robust, independent Federal Consumer Financial Protection Agency to protect consumers from unfair credit, payment and debt management products, no matter what company or bank sells them and no matter what agency may serve as the prudential regulator for that company or bank. We describe the many failures of the current Federal financial regulators. We discuss the need for a return to a system where Federal financial protection law serves as a floor not as a ceiling, and consumers are again protected by the three-legged stool of Federal protection, State enforcement and private enforcement. We rebut anticipated opposition to the proposal, which we expect will come from the companies and regulators that are part of the system that has failed to protect us. We offer detailed suggestions to shape the development of the agency in the legislative process. We believe that, properly implemented, a Consumer Financial Protection Agency will encourage innovation by financial actors, increase competition in the marketplace, and lead to better choices for consumers.

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[16] National Community Reinvestment Coalition is an association of more than 600 community-based organizations that promotes access to basic banking services, including credit and savings, to create and sustain affordable housing, job development, and vibrant communities for America's working families.

[17] The National Consumer Law Center, Inc. is a nonprofit corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, Government, and private attorneys representing low-income consumers across the country. NCLC publishes and regularly updates a series of 16 practice treatises and annual supplements on consumer credit laws, including Truth In Lending, Cost of Credit, Consumer Banking and Payments Law, Foreclosures, and Consumer Bankruptcy Law and Practice, as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for tens of thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all Federal laws affecting consumer credit since the 1970s, and regularly provide comprehensive comments to the Federal agencies on the regulations under these laws.

[18] The National Consumers League has been fighting for the rights of consumers and workers since its founding in 1899. The League was instrumental in seeking a safety net for Americans during the Great Depression and in the New Deal years, writing legislation to gain passage of minimum wage laws, unemployment insurance, workers compensation, social security and health care programs like medicare and medicaid. The League continues to champion the fair treatment and protections for all consumers in today's marketplace.

[19] Founded in 1988, the National Fair Housing Alliance is a consortium of more than 220 private, nonprofit fair housing organizations, State and local civil rights agencies, and individuals from throughout the United States. Headquartered in Washington, DC, the National Fair Housing Alliance, through comprehensive education, advocacy and enforcement programs, provides equal access to apartments, houses, mortgage loans and insurance policies for all residents of the Nation.

[21] Neighborhood Economic Development Advocacy Project (NEDAP) is a resource and advocacy center for community groups in New York City. Their mission is to promote community economic justice and to eliminate discriminatory economic practices that harm communities and perpetuate inequality and poverty.

[22] Public Citizen is a national nonprofit membership organization that has advanced consumer rights in administrative agencies, the courts, and the Congress, for 38 years.

[23] Founded by Sargent Shriver in 1967, the mission of the Sargent Shriver National Center on Poverty Law is to provide national leadership in identifying, developing, and supporting creative and collaborative approaches to achieve social and economic justice for low-income people. The Community Investment Unit of the Shriver Center advances the mission of the organization through innovative and collaborative public policy advocacy to enable low-income people and communities to move from poverty to prosperity.

[24] The Service Employees International Union is North America's largest union with more than 2 million members. SEIU has taken a lead in holding financial institutions, including private equity and big banks, accountable for their impact on working families.

[25] USAction builds power by uniting people locally and nationally, on the ground and online, to win a more just and progressive America. We create and participate the Nation's leading progressive coalitions making democracy work by organizing issue campaigns to improve people's lives. Our 28 State affiliates and partners, and our True Majority online members, bring the voices and concerns of the grassroots inside the Beltway.

[26] The U.S. Public Interest Research Group serves as the federation of and Federal advocacy office for the State PIROs, which are nonprofit, nonpartisan public interest advocacy groups that take on powerful interests on behalf of their members.

We look forward to working with you and Committee Members to enact a strong Consumer Financial Protection Agency bill through the Senate and into law. We also look forward to working with you on other necessary aspects of financial regulatory reform to restore the faith and confidence of American families that the financial system will protect their homes and their economic security.

SECTION 1. LEARNING FROM EXPERIENCE TO CREATE A FEDERAL CONSUMER FINANCIAL PROTECTION AGENCY

It has become clear that a major cause of the most calamitous worldwide recession since the Great Depression was the simple failure of Federal regulators to stop abusive lending, particularly unsustainable home mortgage lending. Such action would not only have protected many families from serious financial harm but would likely have stopped or slowed the chain of events that has led to the current economic crisis.

The idea of a Federal consumer protection agency focused on credit and payment products has gained broad and high-profile support because it targets the most significant underlying causes of the massive regulatory failures that occurred. First, Federal agencies did not make protecting consumers their top priority and, in fact, seemed to compete against each other to keep standards low, ignoring many festering problems that grew worse over time. If agencies did act to protect consumers (and they often did not), the process was cumbersome and time-consuming. As a result, agencies did not act to stop some abusive lending practices until it was too late. Finally, regulators were not truly independent of the influence of the financial institutions they regulated.

Meanwhile, despite an unprecedented Government intervention in the financial sector, the passage of mortgage reform legislation in the House of Representatives and the enactment of a landmark law to prevent abusive credit card lending, problems with the sustainability of home mortgage and consumer loans keep getting worse. With an estimated 2 million households having already lost their homes to foreclosure because of the inability to repay unsound loans, Credit Suisse now predicts that foreclosures will exceed 8 million through 2012.[27] The amount of revolving debt, most of which is credit card debt, is approaching $1 trillion.[28] Based on the losses that credit card issuers are now reporting, delinquencies and defaults are expected to peak at their highest levels ever within the next year.[29] One in two consumers who get payday loans default within the first year, and consumers who receive these loans are twice as likely to enter bankruptcy within 2 years as those who seek and are denied them.[30] Overall, personal bankruptcies have increased sharply, up by one-third in the last year.[31]

The failure of Federal banking agencies to stem subprime mortgage lending abuses is fairly well known. They did not use the regulatory authority granted to them to stop unfair and deceptive lending practices before the mortgage foreclosure crisis spun out of control. In fact, it wasn't until July of 2008 that these rules were finalized, close to a decade after analysts and experts started warning that predatory subprime mortgage lending would lead to a foreclosure epidemic.

Less well known are Federal regulatory failures that have contributed to the extension of unsustainable consumer loans, such as credit card, overdraft and payday loans, which are now imposing a crushing financial burden on many families. As with problems in the mortgage lending market, failures to rein in abusive types of consumer loans were in areas where Federal regulators had existing authority to act, and either chose not to do so or acted too late to stem serious problems in the credit markets.

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[27] "Foreclosures Could Top 8 million: Credit Suisse," 9 December 2008, MarketWatch, available at *http://www.marketwatch.com/story/more-than-8-million-homes-face-foreclosure-in-next-4-years* (last visited 21 June 2009).

[28] See the Federal Reserve statistical release G19, Consumer Credit, available at *http://www.federalreserve.gov/releases/g19/*

[29] "Fitch Inc. said it continues to see signs that the credit crunch will escalate into next year, and it said card chargeoffs may approach 10 percent by this time next year." "Fitch Sees Chargeoffs Nearing 10 percent," Dow Jones, May 5, 2009.

[30] Paige Marta Skiba and Jeremy Tobacman, "Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default," August 21, 2008. *http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=1636* and Paige Marta Skiba and Jeremy Tobacman, "Do Payday Loans Cause Bankruptcy?" October 10, 2008 *http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=2221* (last visited 21 June 2009).

[31] "Bankruptcy Filings Continue to Rise" Administrative Office of the U.S. Courts, news release, 8 June 2009, available at *http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsMar2009.cfm* (last visited 21 June 2009).

Combining safety and soundness supervision—with its focus on bank profitability—in the same institution as consumer protection magnified an ideological predisposition or antiregulatory bias by Federal officials that led to unwillingness to rein in abusive lending before it triggered the housing and economic crises. Though we now know that consumer protection leads to effective safety and soundness, structural flaws in the Federal regulatory system compromised the independence of banking regulators, encouraged them to overlook, ignore, and minimize their mission to protect consumers. This created a dynamic in which regulatory agencies competed against each other to weaken standards and ultimately led to an oversight process that was cumbersome and ineffectual. These structural weaknesses threatened to undermine even the most diligent policies and intentions. They complicated enforcement and vitiated regulatory responsibility to the ultimate detriment of consumers.

These structural flaws include: a narrow focus on "safety and soundness" regulation to the exclusion of consumer protection; the huge conflict-of-interest that some agencies have because they rely heavily on financial assessments on regulated institutions that can choose to pay another agency to regulate them; the balkanization of regulatory authority between agencies that often results in either very weak or extraordinarily sluggish regulation (or both); and a regulatory process that lacks transparency and accountability. Taken together, these flaws severely compromised the regulatory process and made it far less likely that agency leaders would either act to protect consumers or succeed in doing so.

SECTION 2. CORRECTING REGULATORY SHORTCOMINGS BY CREATING A CONSUMER FINANCIAL PROTECTION AGENCY

Although a Consumer Financial Protection Agency (CFPA) would not be a panacea for all current regulatory ills, it would correct many of the most significant structural flaws that exist, realigning the regulatory architecture to reflect the unfortunate lessons that have been learned in the current financial crisis and sharply increasing the chances that regulators will succeed in protecting consumers in the future. A CFPA would be designed to achieve the regulatory goals of elevating the importance of consumer protection, prompting action to prevent harm, ending regulatory arbitrage, and guaranteeing regulatory independence.

A. Put consumer protection at the center of financial regulation.

Right now, four Federal regulatory agencies are required both to ensure the solvency of the financial institutions they regulate and to protect consumers from lending abuses.[32] Jurisdiction over consumer protection statutes is scattered over several more agencies, with rules like RESPA and TILA, which both regulate mortgage disclosures, in different agencies.

Within agencies in which these functions are combined, regulators have often treated consumer protection as less important than their safety and soundness mission or even in conflict with that mission.[33] For example, after more than 6 years of effort by consumer organizations, Federal regulators are just now contemplating incomplete rules to protect consumers from high-cost "overdraft" loans that financial institutions often extend without the knowledge of or permission from consumers. Given the longstanding inaction on this issue, it is reasonable to assume that regulators were either uninterested in consumer protection or viewed restrictions on overdraft loans as an unnecessary financial burden on banks that extend this form of credit, even if it is deceptively offered and financially harmful to consumers. In other words, because regulators apparently decided that their overriding mission was to ensure that the short-term balance sheets of the institutions they regulated were strong, they were less likely to perceive that questionable products or practices (like overdraft loans or mortgage prepayment penalties) were harmful to consumers.

As mentioned above, recent history has demonstrated that this shortsighted view of consumer protection and bank solvency as competing objectives is fatally flawed.

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[32] The Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTC) charter and supervise national banks, and thrifts, respectively. State chartered banks can choose whether to join and be examined and supervised by either the Federal Reserve System or the Federal Deposit Insurance Corporation (FDIC). The FTC is charged with regulating some financial practices (but not safely and soundness) in the nonbank sector, such as credit cards offered by department stores and other retailer.

[33] Occasionally, safety and soundness concerns have led regulators to propose consumer protections, as in the eventually successful efforts by Federal banking agencies to prohibit "rent-a-charter" payday lending, in which payday loan companies partnered with national or out-of-State banks in an effort to skirt restrictive State laws. However, from a consumer protection point-of-view, this multiyear process took far too long. Moreover, the outcome would have been different if the agencies had concluded that payday lending would be profitable for banks and thus contribute to their soundness.

If regulatory agencies had acted to prevent loan terms or practices that harmed consumers, they would also have vastly improved the financial solidity of the institutions they regulated. Nonetheless, the disparity in agencies' focus on consumer protection versus "safety and soundness" has been obvious, both in the relative resources that agencies devoted to the two goals and in the priorities they articulated. These priorities frequently minimized consumer protection and included reducing regulatory restrictions on the institutions they oversaw.[34]

Though the link between consumer protection and safety and soundness is now obvious, the two functions are not the same, and do conflict at times. In some circumstances, such as with overdraft loans, a financial product might well be profitable, even though it is deceptively offered and has a financially devastating effect on a significant number of consumers.[35]

Until recently, regulatory agencies have also focused almost exclusively on bank examination and supervision to protect consumers, which lacks transparency. This process gives bank regulators a high degree of discretion to decide what types of lending are harmful to consumers, a process that involves negotiating behind-the-scenes with bank officials.[36] Given that multiple regulators oversee similar institutions, the process has also resulted in different standards for products like credit cards offered by different types of financial institutions. In fact, widespread abusive lending in the credit markets has discredited claims by bank regulators like the Comptroller of the Currency that a regulatory process consisting primarily of supervision and examination results in a superior level of consumer protection compared to taking public enforcement action against institutions that violate laws or rules.[37] Financial regulatory enforcement actions are a matter of public record which has a positive impact on other providers who might be engaged in the same practices and provides information to consumers on financial practices sanctioned by regulators.

Additionally, the debate about the financial and foreclosure crisis often overlooks the fact that predatory lending practices and the ensuing crisis have had a particularly harsh impact on communities of color. African Americans and Latinos suffered the brunt of the predatory and abusive practices found in the subprime market. While predatory and abusive lending practices were not exclusive to the subprime market, because of lax regulation in that sector, most abuses were concentrated there. Several studies have documented pervasive racial discrimination in the distribution of subprime loans. One such study found that borrowers of color were more than 30 percent more likely to receive a higher-rate loan than White borrowers even after accounting for differences in creditworthiness.[38] Another study found that high-income African Americans in predominantly Black neighborhoods were three times more likely to receive a subprime purchase loan than low-income White borrowers.[39]

African Americans and Latinos receive a disproportionate level of high cost loans, even when they quality for a lower rate and/or prime mortgage. Fannie Mae and

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[34] For example, in 2007 the OTS cited consumer protection as part of its "mission statement" and "strategic goals and vision." However, in identifying its eight "strategic priorities" for how it would spend its budget in Fiscal Year 2007, only part of one of these priorities appears to be directly related to consumer protection ("data breaches"). On the other hand, OTS identified both "Regulatory Burden Reduction" and "Promotion of the Thrift Charter" as major strategic budget priorities. Office of Thrift Supervision, "OMB FY2007 Budget and Performance Plan," January 2007.

[35] Testimony of Travis Plunkett, Legislative Director, Consumer Federation of America and Edmund Mierzwinski, Consumer Program Director, U.S. PIRG, Before the Subcommittee on Financial Institutions and Consumer Credit of the U.S. House of Representatives, Committee of Financial Services, March 19, 2009.

[36] "Findings made during compliance examinations are strictly confidential and are not made available to the public except at the OCC's discretion. Similarly, the OCC is not required to publish the results of its safety-and-soundness orders . . . . Thus, the OCC's procedures for compliance examinations and safety-and-soundness orders do not appear to provide any public notice or other recourse to consumers who have been injured by violations identified by the OCC." Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, before the Subcommittee on Financial Institutions and Consumer Credit of the House Financial Services Committee, April 26, 2007.

[37] " . . . ours is not an 'enforcement-only' compliance regime—far better to describe our approach as 'supervision first, enforcement if necessary,' with supervision addressing so many early problems that enforcement is not necessary," Testimony of John C. Dugan, Comptroller of the Currency, before the Committee on Financial Services of the U.S. House of Representatives, June 13, 2007.

[38] See Bocian, D.G., K.S. Ernst, and W. Li, "Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages," Center for Responsible Lending, May 2006.

[39] "Unequal Burden: Income and Racial Disparities in Subprime Lending in America" (Washington, DC: HUD, 2000).

Freddie Mac estimated that up to 50 percent of those who ended up with a sub prime loan would have qualified for a mainstream, "prime-rate" conventional loan in the first place.[40] According to a study conducted by the *Wall Street Journal,* as much as 61 percent of those receiving subprime loans would "qualify for conventional loans with far better terms."[41] Moreover, racial segregation is linked with the proportion of subprime loans originated at the metropolitan level, even after controlling for percent minority, low credit scores, poverty, and median home value.[42] The resulting flood of high cost and abusive loans in communities of color has artificially elevated the costs of homeownership, caused unprecedented high rates of foreclosures, and contributed to the blight and deterioration of these neighborhoods. It is estimated that communities of color will realize the greatest loss of wealth as a result of this crisis, since Reconstruction.

A CFPA, by contrast, would have as its sole mission the development and effective implementation of standards that ensure that all credit products offered to borrowers are safe and not discriminatory. The agency would then enforce these standards for the same types of products in a transparent, uniform manner. Ensuring the safety and fairness of credit products would mean that the CFPA would not allow loans with terms that are discriminatory, deceptive or fraudulent. The agency should also be designed to ensure that credit products are offered in a fair and sustainable manner. In fact, a core mission of the CFPA would be to ensure the suitability of classes of borrowers for various credit products, based on borrowers' ability to repay the loans they are offered—especially if the cost of loans suddenly or sharply increase, and that the terms of loans do not impose financial penalties on borrowers who try to pay them off. As we've learned in the current crisis, focusing exclusively on consumer and civil rights protection would often be positive for lenders' stability and soundness over the long term. However, the agency would be compelled to act in the best interest of consumers even if measures to restrict certain types of loans would have a negative short-term financial impact on financial institutions.

B. Prevent regulatory arbitrage. Act quickly to prevent unsafe forms of credit.

The present regulatory system is institution centered, rather than consumer centered. It is structured according to increasingly irrelevant distinctions between the type of financial services company that is lending money, rather than the type of product being offered to consumers. Right now, financial institutions are allowed (and have frequently exercised their right) to choose the regulatory body that oversees them and to switch freely between regulatory charters at the Federal level and between State and Federal charters. Many financial institutions have switched charters in recent years seeking regulation that is less stringent. Two of the most notorious examples are Washington Mutual and Countrywide,[43] which became infamous for promoting dangerous sub-prime mortgage loans on a massive scale.[44] Both switched their charters to become thrifts regulated by the Office of Thrift Supervision (OTS). At the Federal level, where major agencies are funded by the institutions they oversee, this ability to "charter shop," has undeniably led regulators like the OTS to compete to attract financial institutions by keeping regulatory standards weak. It has also encouraged the OTS and OCC to expand their preemptive authority and stymie efforts by the States to curb predatory and high-cost lending. The OCC in particular appears to have used its broad preemptive authority over State

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[40] See the Center for Responsible Lending's "Fact Sheet on Predatory Mortgage Lending", at *http://www.responsiblelending.org/pdfs/2b003-mortgage2005.pdf,* and "The Impending Rate Shock: A Study of Home Mortgages in 130 American Cities", ACORN, August 15, 2006, available at *www.acorn.org.*

[41] See "Subprime Debacle Traps Even Very Creditworthy", *Wall Street Journal,* December 3, 2007.

[42] Squires, Gregory D., Derek S. Hyra, and Robert N. Renner, "Segregation and the Subprime Lending Crisis", Paper presented at the 2009 Federal Reserve System Community Affairs Research Conference, Washington, DC (April 16, 2009).

[43] Of course, following their stunning collapses, Countrywide was acquired by Bank of America and Washington Mutual by Chase, both in regulator-ordered winding-downs.

[44] In fact, several other large national banks have chosen in recent years to convert their State charter to a national charter. Charter switches by JPMorgan Chase, HSBC, and Bank of Montreal (Harris Trust) alone in 2004–05 moved over $1 trillion of banking assets from the State to the national banking system, increasing the share of assets held by national banks to 67 percent from 56 percent, and decreasing the State share to 33 percent from 44 percent. Arthur E. Wilmarth, Jr., "The OCC's Preemption Rules Threaten to Undermine the Dual Banking System, Consumer Protection and the Federal Reserve Board's role in Bank Supervision", Proceedings of the 42nd Annual Conference on Bank Structure and Competition (Fed. Res. Bank of Chicago, 2006) at 102, 105–106.

consumer protections and its aggressive legal defense of that authority as a marketing tool to attract depository institutions to its charter.[45]

When agencies do collaborate to apply consumer protections consistently to the institutions they regulate, the process has been staggeringly slow. As cited in several places in this testimony, Federal regulators dithered for years in implementing regulations to stop unfair and deceptive mortgage and credit card lending practices. One of the reasons for these delays has often been that regulators disagree among themselves regarding what regulatory measures must be taken. The course of least resistance in such cases is to do nothing, or to drag out the process. Although the credit card rule adopted late last year by Federal regulators was finalized over protests from the OCC, these objections were likely one of the reasons that Federal regulators delayed even beginning the process of curbing abusive credit card lending practices until mid-2008.

The "charter shopping" problem would be directly addressed through the creation of a single CFPA with regulatory authority over all forms of credit. Federal agencies would no longer compete to attract institutions based on weak consumer protection standards or anemic enforcement of consumer rules. The CFPA would be required to focus on the safety of credit products, features and practices, no matter what kind of lender offered them. As for regulatory competition with States, it would only exist to improve the quality of consumer protection. Therefore, the CFPA should be allowed to set minimum national credit standards, which States could then enforce (as well as victimized consumers). States would be allowed to exceed these standards if local conditions require them to do so. If the CFPA sets "minimum" standards that are sufficiently strong, a high degree of regulatory uniformity is likely to result. With strong national minimum standards in place, States are most likely to act only when new problems develop first in one region or submarket. States would then serve as an early warning system, identifying problems as they develop and testing policy solutions, which could then be adopted nationwide by the CFPA if merited. Moreover, the agency would have a clear incentive to stay abreast of market developments and to act in a timely fashion to rein in abusive lending because it will be held responsible for developments in the credit market that harm consumers.

C. Create an independent regulatory process.

The ability of regulated institutions to "charter shop" combined with aggressive efforts by Federal regulators to preempt State oversight of these institutions has clearly undermined the independence of the OTS and OCC. This situation is made worse by the fact that large financial institutions like Countrywide were able to increase their leverage over regulators by taking a significant chunk of the agency's budget away when it changed charters and regulators. The OTS and OCC are almost entirely funded through assessments on the institutions they regulate (see Appendix 4). The ability to charter shop combined with industry funding has created a significant conflict-of-interest that has contributed to the agencies' disinclination to consider upfront regulation of the mortgage and consumer credit markets.

Given that it supervises the largest financial institutions in the country, the OCC's funding situation is the most troublesome.

> More than 95 percent of the OCC's budget is financed by assessments paid by national banks, and the twenty biggest national banks account for nearly three-fifths of those assessments. Large, multistate banks were among the most outspoken supporters of the OCC's preemption regulations and were widely viewed as the primary beneficiaries of those rules. In addition to its preemption regulations, the OCC has frequently filed amicus briefs in Federal court cases to support the efforts of national banks to obtain court decisions preempting State laws. The OCC's effort to attract large, multistate banks to the national system have already paid handsome dividends to the agency . . . . Thus, the OCC has a powerful financial interest in pleasing its largest regulated constituents, and the OCC therefore faces a clear conflict of interest whenever it considers the possibility of taking an enforcement action against a major national bank.[46]

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[45] For a detailed analysis, see *brief amicus curiae* of Center for Responsible Lending *et al.* in the case currently before the Supreme Court, *Cuomo v. Clearinghouse and OCC* (08-453) available at *http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/08-453_PetitionerAmCu10ConsumerProtectionOrgs.pdf* (last visited 21 June 2009) at pp. 20–39.

[46] Testimony of Arthur E. Wilmarth. Jr., Professor of Law, George Washington University Law School, before the Subcommittee on Financial Institutions and Consumer Credit of the House Financial Services Committee, April 26, 2007.

The leadership sofa CFPA would be held to account based on its ability to inform consumers and help protect them from unsafe products. In order to function effectively, the leadership would need to show expertise in and commitment to consumer protection. Crucial to the success of the agency would be to ensure that its funding is adequate, consistent and does not compromise this mission. Congress could also ensure that the method of agency funding that is used does not compromise the CFPA's mission by building accountability mechanisms into the authorizing statute and exercising effective oversight of the agency's operations. (See Section 4 below.)

Recent history has demonstrated that even an agency with an undiluted mission to protect consumers can be undermined by hostile or negligent leadership or by Congressional meddling on behalf of special interests. However, unless the structure of financial services regulation is realigned to change not just the focus of regulation but its underlying philosophy, it is very unlikely that consumers will be adequately protected from unwise or unfair credit products in the future. The creation of a CFPA is necessary because it ensures that the paramount priority of Federal regulation is to protect consumers, that the agency decision making is truly independent, and that agencies do not have financial or regulatory incentives to keep standards weaker than necessary.

SECTION 3: ERRORS OF OMISSION AND COMMISSION BY THE FEDERAL BANK REGULATORS

Current regulators may already have some of the powers that the new agency would be given, but they haven't used them. Conflicts of interest and a lack of will work against consumer enforcement. In this section, we detail numerous actions and inactions by the Federal banking regulators that have led to or encouraged unfair practices, higher prices for consumers, and less competition.

A. The Federal Reserve Board ignored the growing mortgage crisis for years after receiving Congressional authority to enact antipredatory mortgage lending rules in 1994.

The Federal Reserve Board was granted sweeping antipredatory mortgage regulatory authority by the 1994 Home Ownership and Equity Protection Act (HOEPA). Final regulations were issued on 30 July 2008 only after the world economy had collapsed due to the collapse of the U.S. housing market triggered by predatory lending.[47]

B. At the same time, the Office of the Comptroller of the Currency engaged in an escalating pattern of preemption of State laws designed to protect consumers from a variety of unfair bank practices and to quell the growing predatory mortgage crisis, culminating in its 2004 rules preempting both State laws and State enforcement of laws over national banks and their subsidiaries.

In interpretation letters, amicus briefs and other filings, the OCC preempted State laws and local ordinances requiring lifeline banking (NJ 1992, NY, 1994), prohibiting fees to cash "on-us" checks (par value requirements) (TX, 1995), banning ATM surcharges (San Francisco, Santa Monica and Ohio and Connecticut, 1998-2000), requiring credit card disclosures (CA, 2003) and opposing predatory lending and ordinances (numerous States and cities).[48] Throughout, OCC ignored Congressional requirements accompanying the 1994 Riegle-Neal Act not to preempt without going through a detailed preemption notice and comment procedure, as the Congress had found many OCC actions "inappropriately aggressive."[49]

In 2000–2004, the OCC worked with increasing aggressiveness to prevent the States from enforcing State laws and stronger State consumer protection standards against national banks and their operating subsidiaries, from investigating or monitoring national banks and their operating subsidiaries, and from seeking relief for consumers from national banks and subsidiaries.

These efforts began with interpretative letters stopping State enforcement and State standards in the period up to 2004, followed by OCC's wide-ranging preemption regulations in 2004 purporting to interpret the National Bank Act, plus briefs in court cases supporting national banks' efforts to block State consumer protections.

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[47] 73 FR 147, p. 44522, Final HOEPA Rule, 30 July 2008.

[48] "Role of the Office of Thrift Supervision and Office of the Comptroller of the Currency in the Preemption of State Law", USGAO, prepared for Financial Services Committee Chairman James Leach, 7 February 2000, available at *http://www.gao.gov/corresp/ggd-00-51r.pdf* (last visited 21 June 2009).

[49] Statement of managers filed with the conference report on H.R. 3841, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Congressional Record Page S10532, 3 August 1994.

We discuss these matters in greater detail below, in Section 5, rebutting industry arguments against the CFPA.

C. The agencies took little action except to propose greater disclosures, as unfair credit card practices increased over the years, until Congress stepped in.

Further, between 1995 and 2007, the Office of the Comptroller of Currency issued only one public enforcement action against a Top Ten credit card bank (and then only after the San Francisco District Attorney had brought an enforcement action). In that period, "the OCC has not issued a public enforcement order against any of the eight largest national banks for violating consumer lending laws."[50] The OCC's failure to act on rising credit card complaints at the largest national banks triggered Congress to investigate, resulting in passage of the 2009 Credit Card Accountability, Responsibility and Disclosure Act (CARD Act).[51] While this Committee was considering that law, other Federal regulators finally used their authority under the Federal Trade Commission Act to propose and finalize a similar rule.[52] By contrast, the OCC requested the addition of two significant loopholes to a key protection of the proposed rule.

Meanwhile, this Committee and its Subcommittee on Financial Institutions and Consumer Credit had conducted numerous hearings on the impact of current credit card issuer practices on consumers. The Committee heard testimony from academics and consumer representatives regarding abusive lending practices that are widespread in the credit card industry, including:

- The unfair application of penalty and "default" interest rates that can rise above 30 percent;
- Applying these interest rate hikes retroactively on existing credit card debt, which can lead to sharp increases in monthly payments and force consumers on tight budgets into credit counseling and bankruptcy;
- High and increasing "penalty" fees for paying late or exceeding the credit limit. Sometimes issuers use tricks or traps to illegitimately bring in fee income, such as requiring that payments be received in the late morning of the due date or approving purchases above the credit limit;
- Aggressive credit card marketing directed at college students and other young people;
- Requiring consumers to waive their right to pursue legal violations in the court system and forcing them to participate in arbitration proceedings if there is a dispute, often before an arbitrator with a conflict of interest; and
- Sharply raising consumers' interest rates because of a supposed problem a consumer is having paying another creditor. Even though few credit card issuers now admit to the discredited practice of "universal default," eight of the ten largest credit card issuers continue to permit this practice under sections in cardholder agreements that allow issuers to change contract terms at "any time for any reason."[53]

In contrast to this absence of public enforcement action by the OCC against major national banks, State officials and other Federal agencies have issued numerous enforcement orders against leading national banks or their affiliates, including Bank of America, Bank One, Citigroup, Fleet, JPMorgan Chase, and USBancorp—for a wide variety of abusive practices over the past decade.[54]

The OCC and PRB were largely silent while credit card issuers expanded efforts to market and extend credit at a much faster speed than the rate at which Americans have taken on credit card debt. This credit expansion had a disproportionately negative effect on the least sophisticated, highest risk and lowest income households. It has also resulted in both relatively high losses for the industry and record profits. That is because, as mentioned above, the industry has been very aggressive

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[50] Testimony of Professor Arthur Wilmarth, 26 April 2007, before the Subcommittee on Financial Institutions and Consumer Credit, hearing on Credit Card Practices: Current Consumer and Regulatory Issues at *http://www.house.gov/financialservices/hearing110/htwilmarth042607.pdf.*

[51] H.R. 627 was signed into law by President Obama as Pub. L. No. 111-24 on 22 May 2009.

[52] The final rule was published in the Federal Register a month later. 74 FR 18, page 5498 Thursday, January 29, 2009.

[53] Testimony of Linda Sherry of Consumer Action, House Subcommittee on Financial Institutions and Consumer Credit, April 26, 2007.

[54] Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, April 26, 2007.

in implementing a number of new—and extremely costly—fees and interest rates.[55] Although the agencies did issue significant guidance in 2003 to require issuers to increase the size of minimum monthly payments that issuers require consumers to pay,[56] neither agency has proposed any actions (or asked for the legal authority to do so) to rein in aggressive lending or unjustifiable fees and interest rates.

In addition, in 1995 the OCC amended a rule, with its action later upheld by the Supreme Court,[57] that allowed credit card banks to export fees nationwide, as if they were interest, resulting in massive increases in the size of penalty late and overdraft fees.

D. The Federal Reserve has allowed debit card cash advances (overdraft loans) without consent, contract, cost disclosure, or fair repayment terms.

The FRB has refused to require banks to comply with the Truth in Lending Act (TILA) when they loan money to customers who are permitted to overdraw their accounts. While the FRB issued a staff commentary clarifying that TILA applied to payday loans, the Board has refused in several proceedings to apply the same rules to banks that make nearly identical loans.[58] As a result, American consumers spend at least $17.5 billion per year on cash advances from their banks without signing up for the credit and without getting cost-of-credit disclosures or a contract stating that the bank would in fact pay overdrafts. Consumers are induced to withdraw more cash at ATMs than they have in their account and spend more than they have with debit card purchases at point of sale. In both cases, the bank could simply deny the transaction, saving consumers average fees of $35 each time.

The FRB has permitted banks to avoid TILA requirements because bankers claim that systematically charging unsuspecting consumers very high fees for overdraft loans they did not request is the equivalent to occasionally covering a paper check that would otherwise bounce. Instead of treating short term bank loans in the same manner as all other loans covered under TILA, as consumer organizations recommended, the FRB issued and updated regulations under the Truth in Savings Act, pretending that finance charges for these loans were bank "service fees." In several dockets, national consumer organizations provided well-researched comments, urging the Federal Reserve to place consumer protection ahead of bank profits, to no avail.

As a result, consumers unknowingly borrow billions of dollars at astronomical interest rates. A $100 overdraft loan with a $35 fee that is repaid in 2 weeks costs 910 percent APR. The use of debit cards for small purchases often results in consumers paying more in overdraft fees than the amount of credit extended. The FDIC found last year that the average debit card point of purchase overdraft is just $20, while the sample of State banks surveyed by the FDIC charged a $27 fee. If that $20 overdraft loan were repaid in two weeks, the FDIC noted that the APR came to 3,520 percent.[59]

As the Federal Reserve has failed to protect bank account customers from unauthorized overdraft loans, banks are raising fees and adding new ones. In the CFA survey of the 16 largest banks updated in July 2009, we found that 14 of the 16 largest banks charge $35 or more for initial or repeat overdrafts and nine of the largest banks use a tiered fee structure to escalate fees over the year. For example, USBank charges $19 for the first overdraft in a year, $35 for the second to fourth overdraft, and $37.50 thereafter. Ten of the largest banks charge a sustained over-

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[55] Testimony of Travis B. Plunkett of the Consumer Federation of America, Senate Banking Committee, January 25, 2007.

[56] Joint press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, "FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices," January 8, 2003, see attached "Account Management and Loss Allowance Guidance" at 3.

[57] The rule is at 12 C.F.R. §7.4001(a). The case is *Smiley v. Citibank,* 517 U.S. 735.

[58] National Consumer Law Center and Consumer Federation of America, Comments to the Federal Reserve Board, Docket No. R-1136, January 27, 2003. Appendix "Bounce Protection: How Banks Turn Rubber Into Gold by Enticing Consumers To Write Bad Checks." Also, CFA, Consumers Union, and U.S. Public Interest Research Group, Supplemental Comments relating to Docket R-1136, May 2, 2003. CFA, *et al.* Comments to the Federal Reserve System, 12 CFR Part 230, Docket No. R-1197, Proposed Amendments to Regulation DD, August 6, 2004. Letter from CFA and national groups to the Chairman of the Federal Reserve Board and Federal Bank Regulators, urging Truth in Lending for overdraft loans, June 8, 2005. CFA, *et al.,* Comments, Federal Reserve System, OTS, and NCUA, FRB Docket No. R-1314, OTS-2008-0004, NCUA RIN 3133-AD47, August 4, 2008. CFA Comments, Federal Reserve System, FRB Docket No. R-1343, March 30, 2009.

[59] FDIC Study of Bank Overdraft Programs, Federal Deposit Insurance Corporation, November 2008 at v.

draft fee, imposing additional fees if the overdraft and fees are not repaid within days. Bank of America began in June to impose a second $35 fee if an overdraft is not repaid within 5 days. As a result, a Bank of America customer who is permitted by her bank to overdraw by $20 with a debit card purchase can easily be charged $70 for a 5 day extension of credit.[60] (For more detail, please see CFA Survey: Sixteen Largest Bank Overdraft Fees and Terms, Appendix 5.)

Cash advances on debit cards are not protected by the Truth in Lending Act prohibition on banks using set off rights to collect payment out of deposits into their customers' accounts. If the purchase involved a credit card, on the other hand, it would violate Federal law for a bank to pay the balance owed from a checking account at the same bank. Banks routinely pay back debit card cash advances to themselves by taking payment directly out of consumers' checking accounts, even if those accounts contain entirely exempt funds such as Social Security.

The Federal Reserve is considering comments filed in yet another overdraft loan docket, this time considering whether to require banks to permit consumers to opt-out of fee-based overdraft programs, or, alternatively, to require banks to get consumers to opt in for overdrafts. This proposal would change Reg E which implements the Electronic Fund Transfer Act and would only apply to overdrafts created by point of sale debit card transactions and to ATM withdrawals, leaving all other types of transactions that are permitted to overdraw for a fee unaddressed. Consumer organizations urged the Federal Reserve to require banks to get their customers' affirmative consent, the same policy included in the recently enacted credit card bill which requires affirmative selection for creditors to permit over-the-limit transactions for a fee.[61]

E. The Fed is allowing a shadow banking system (prepaid cards) outside of consumer protection laws to develop and target the unbanked and immigrants; The OTS is allowing bank payday loans (which preempt State laws) on prepaid cards.

The Electronic Funds Transfer Act requires key disclosures of fees and other practices, protects consumer bank accounts from unauthorized transfers, requires resolution of billing errors, gives consumers the right to stop electronic payments, and requires Statements showing transaction information, among other protections. The EFTA is also the statute that will hold the new protections against overdraft fee practices that the Fed is writing.

Yet the Fed has failed to include most prepaid cards in the EFTA's protections, even while the prepaid industry is growing and is developing into a shadow banking system. In 2006, the Fed issued rules including payroll cards—prepaid cards that are used to pay wages instead of a paper check for those who do not have direct deposit to a bank account—within the definition of the "accounts" subject to the EFTA. But the Fed permitted payroll card accounts to avoid the Statement requirements for bank accounts, relying instead on the availability of account information on the Internet. Forcing consumers to monitor their accounts online to check for unauthorized transfers and fees and charges is particularly inappropriate for the population targeted for these cards: consumers without bank accounts, who likely do not have or use regular Internet access.

Even worse, the Fed refused to adopt the recommendations of consumer groups that self-selected payroll cards—prepaid cards that consumers shop for and choose on their own as the destination for direct deposit of their wages—should receive the same EFTA protections that employer designated payroll cards receive. The Fed continues to take the position that general prepaid cards are not protected by the EFTA.

This development has become all the more glaring as Federal and State government agencies have moved to prepaid cards to pay many Government benefits, from Social Security and Indian Trust Funds to unemployment insurance and State-collected child support. Some agencies, such as the Treasury Department when it created the Social Security Direct Express Card, have included in their contract requirements that the issuer must comply with the EFTA. But not all have, and compliance is uneven, despite the fact that the EFTA itself clearly references and anticipates coverage of electronic systems for paying unemployment insurance and other non-needs-tested Government benefits.

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[60] Bank of America, "Important Information Regarding Changes to Your Account" p. 2. Accessed online June 15, 2009. "Extended Overdrawn Balance Charge, June 5, 2009: For each time we determine your account is overdrawn by any amount and continues to be overdrawn for 5 or more consecutive business days, we will charge one fee of $35. This fee is in addition to applicable Overdraft Item Fees and NSF Returned Item Fees."

[61] Federal Reserve Board, Docket No. R-1343, comments were due March 30, 2009.

The Fed's failure to protect this shadow banking system is also disturbing as prepaid cards are becoming a popular product offered by many predatory lenders, like payday lenders.

Indeed, the Fed is not the only one that has recently dropped the ball on consumer protection on prepaid cards. One positive effort by the banking agencies in the past decade was the successful effort to end rent-a-bank partnerships that allowed payday lenders to partner with depositories to use their preemptive powers to preempt State payday loan laws.[62] But more recently, one prepaid card issuer, Meta Bank, has developed a predatory, payday loan feature—iAdvance—on its prepaid cards that receive direct deposit of wages and Government benefits. At a recent conference, an iAdvance official boasted that Meta Bank's regulator—the OTS—has been very "flexible" with them and "understands" this product.

F. Despite advances in technology, the Federal Reserve has refused to speed up availability of deposits to consumers.

Despite rapid technological changes in the movement of money electronically, the adoption of the Check 21 law to speed check processing, and electronic check conversion at the cash register, the Federal Reserve has failed to shorten the amount of time that banks are allowed to hold deposits before they are cleared. Money flies out of bank accounts at warp speed. Deposits crawl in. Even cash that is deposited over the counter to a bank teller can be held for 24 hours before becoming available to cover a transaction. The second business day rule for local checks means that a low-income worker who deposits a pay check on Friday afternoon will not get access to funds until the following Tuesday. If the paycheck is not local, it can be held for five business days. This long time period applies even when the check is written on the same bank where it is deposited. Consumers who deposit more than $5,000 in one day face an added wait of about 5 to 6 more business days. Banks refuse to cash checks for consumers who do not have equivalent funds already on deposit. The combination of unjustifiably long deposit holds and banks' refusal to cash account holders' checks pushes low income consumers towards check cashing outlets, where they must pay 2 to 4 percent of the value of the check to get immediate access to cash.

Consumer groups have called on the Federal Reserve to speed up deposit availability and to prohibit banks from imposing overdraft or insufficient fund (NSF) fees on transactions that would not have overdrawn if deposits had been available. The Federal Reserve vigorously supported Check 21, which has speeded up withdrawals but has refused to reduce the time period for local and nonlocal check hold periods for consumers.

G. The Federal Reserve has supported the position of payday lenders and telemarketing fraud artists by permitting remotely created checks (demand drafts) to subvert consumer rights under the electronic funds transfer act.

In 2005, the National Association of Attorneys General, the National Consumer Law Center, Consumer Federation of America, Consumers Union, the National Association of Consumer Advocates, and U.S. Public Interest Research Group filed comments with the Federal Reserve in Docket No. R-1226, regarding proposed changes to Regulation CC with respect to demand drafts. Demand drafts are unsigned checks created by a third party to withdraw money from consumer bank accounts. State officials told the FRB that demand drafts are frequently used to perpetrate fraud on consumers and that the drafts should be eliminated in favor of electronic funds transfers that serve the same purpose and are covered by protections in the Electronic Funds Transfer Act. Since automated clearinghouse transactions are easily traced, fraud artists prefer to use demand drafts. Fraudulent telemarketers increasingly rely on bank debits to get money from their victims. The Federal Trade Commission earlier this year settled a series of cases against telemarketers who used demand drafts to fraudulently deplete consumers' bank accounts. Fourteen defendants agreed to pay a total of more than $16 million to settle FTC charges while Wachovia Bank paid $33 million in a settlement with the Comptroller of the Currency.[63]

Remotely created checks are also used by high cost lenders to remove funds from checking accounts even when consumers exercise their right to revoke authorization to collect payment through electronic funds transfer. CFA first issued a report on

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[62] Payday lending is so egregious that even the Office of the Comptroller of the Currency refused to let storefront lenders hide behind their partner banks' charters to export usury.

[63] Press Release, "Massive Telemarketing Scheme Affected Nearly One Million Consumers Nationwide; Wachovia Bank To Provide an Additional $33 Million to Suntasia Victims," Federal Trade Commission, January 13, 2009, viewed at *http://www.ftc.gov/opa/2009/01/suntasia.shtm.*

Internet payday lending in 2004 and documented that some high-cost lenders converted debts to demand drafts when consumers exercised their EFTA right to revoke authorization to electronically withdraw money from their bank accounts. CFA brought this to the attention of the Federal Reserve in 2005, 2006, and 2007. No action has been taken to safeguard consumers' bank accounts from unauthorized unsigned checks used by telemarketers or conversion of a loan payment from an electronic funds transfer to a demand draft to thwart EFTA protections or exploit a loophole in EFTA coverage.

The structure of online payday loans facilitates the use of demand drafts. Every application for a payday loan requires consumers to provide their bank account routing number and other information necessary to create a demand draft as well as boiler plate contract language to authorize the device. The account information is initially used by online lenders to deliver the proceeds of the loan into the borrower's bank account using the ACH system. Once the lender has the checking account information, however, it can use it to collect loan payments via remotely created checks per boilerplate contract language even after the consumer revokes authorization for the lender to electronically withdraw payments.

The use of remotely created checks is common in online payday loan contracts. ZipCash LLC "Promise to Pay" section of a contract included the disclosure that the borrower may revoke authorization to electronically access the bank account as provided by the Electronic Fund Transfer Act. However, revoking that authorization will not stop the lender from unilaterally withdrawing funds from the borrower's bank account. The contract authorizes creation of a demand draft which cannot be terminated. "While you may revoke the authorization to effect ACH debit entries at any time up to 3 business days prior to the due date, *you may not revoke the authorization to prepare and submit checks on your behalf until such time as the loan is paid in full.*" (Emphasis added.)[64]

H. The Federal Reserve has taken no action to safeguard bank accounts from Internet payday lenders.

In 2006, consumer groups met with Federal Reserve staff to urge them to take regulatory action to protect consumers whose accounts were being electronically accessed by Internet payday lenders. We joined with other groups in a follow up letter in 2007, urging the Federal Reserve to make the following changes to Regulation E:

- Clarify that remotely created checks are covered by the Electronic Funds Transfer Act.
- Ensure that the debiting of consumers' accounts by Internet payday lenders is subject to all the restrictions applicable to preauthorized electronic funds transfers.
- Prohibit multiple attempts to "present" an electronic debit.
- Prohibit the practice of charging consumers a fee to revoke authorization for preauthorized electronic funds transfers.
- Amend the Official Staff Interpretations to clarify that consumers need not be required to inform the payee in order to stop payment on preauthorized electronic transfers.

While FRB staff was willing to discuss these issues, the FRB took no action to safeguard consumers when Internet payday lenders and other questionable creditors evade consumer protections or exploit gaps in the Electronic Fund Transfer Act to mount electronic assaults on consumers' bank accounts.

As a result of inaction by the Federal Reserve, payday loans secured by repeat debit transactions undermine the protections of the Electronic Fund Transfer Act, which prohibits basing the extension of credit with periodic payments on a requirement to repay the loan electronically.[65] Payday loans secured by debit access to the borrower's bank account which cannot be cancelled also functions as the modern banking equivalent of a wage assignment—a practice which is prohibited when done directly. The payday lender has first claim on the direct deposit of the borrower's next paycheck or exempt Federal funds, such as Social Security, SSI, or Veterans Benefit payments. Consumers need control of their accounts to decide which bills get paid first and to manage scarce family resources. Instead of using its authority

[64] Loan Supplement (ZipCash LLC) Form #2B, on file with CFA.

[65] Reg E, 12 C.F.R. §205.10(e). 15 U.S.C. §1693k states that "no person" may condition extension of credit to a consumer on the consumer's repayment by means of a preauthorized electronic fund transfer.

to safeguard electronic access to consumers' bank accounts, the Federal Reserve has stood idly by as the online payday loan industry has expanded.

I. The banking agencies have failed to stop banks from imposing unlawful freezes on accounts containing social security and other funds exempt from garnishment.

Federal benefits including Social Security and Veteran's benefits (as well as State equivalents) are taxpayer dollars targeted to relieve poverty and ensure minimum subsistence income to the Nation's workers. Despite the purposes of these benefits, banks routinely freeze bank accounts containing these benefits pursuant to garnishment or attachment orders, and assess expensive fees—especially insufficient fund (NSF) fees—against these accounts.

The number of people who are being harmed by these practices has escalated in recent years, largely due to the increase in the number of recipients whose benefits are electronically deposited into bank accounts. This is the result of the strong Federal policy to encourage this in the Electronic Funds Transfer Act. And yet, the banking agencies have failed to issue appropriate guidance to ensure that the millions of Federal benefit recipients receive the protections they are entitled to under Federal law.

J. The Comptroller of the Currency permits banks to manipulate payment order to extract maximum bounced check and overdraft fees, even when overdrafts are permitted.

The Comptroller of the Currency permits national banks to rig the order in which debits are processed. This practice increases the number of transactions that trigger an overdrawn account, resulting in higher fee income for banks. When banks began to face challenges in court to the practice of clearing debits according to the size of the debit—from the largest to the smallest—rather than when the debit occurred or from smallest to largest check, the OCC issued guidelines that allow banks to use this dubious practice.

The OCC issued an Interpretive Letter allowing high-to-low check clearing when banks follow the OCC's considerations in adopting this policy. Those considerations include: the cost incurred by the bank in providing the service; the deterrence of misuse by customers of banking services; the enhancement of the competitive position of the bank in accordance with the bank's business plan and marketing strategy; and the maintenance of the safety and soundness of the institution.[66] None of the OCC's considerations relate to consumer protection.

The Office of Thrift Supervision (OTS) addressed manipulation of transaction-clearing rules in the Final Guidance on Thrift Overdraft Programs issued in 2005. The OTS, by contrast, advised thrifts that transaction-clearing rules (including check-clearing and batch debit processing) should not be administered unfairly or manipulated to inflate fees.[67] The Guidelines issued by the other Federal regulatory agencies merely urged banks and credit unions to explain the impact of their transaction clearing policies. The Interagency "Best Practices" State: "Clearly explain to consumers that transactions may not be processed in the order in which they occurred, and that the order in which transactions are received by the institution and processed can affect the total amount of overdraft fees incurred by the consumers."[68]

CFA and other national consumer groups wrote to the Comptroller and other Federal bank regulators in 2005 regarding the unfair trade practice of banks ordering withdrawals from high-to-low, while at the same time unilaterally permitting overdrafts for a fee. One of the OCC's "considerations" is that the overdraft policy should "deter misuse of bank services." Since banks deliberately program their computers to process withdrawals high-to-low and to permit customers to overdraw at the ATM and Point of Sale, there is no "misuse" to be deterred.

No Federal bank regulator took steps to direct banks to change withdrawal order to benefit low-balance consumers or to stop the unfair practice of deliberately causing more transactions to bounce in order to charge high fees. CFA's survey of the 16 largest banks earlier this year found that all of them either clear transactions largest first or reserve the right to do so.[69] Since ordering withdrawals largest first is likely to deplete scarce resources and trigger more overdraft and insufficient

[66] 12 C.F.R. 7.4002(b).

[67] Office of Thrift Supervision, Guidance on Overdraft Protection Programs, February 14, 2005, p. 15.

[68] Department of Treasury, Joint Guidance on Overdraft Protection Programs, February 15, 2005, p. 13.

[69] Consumer Federation of America, Comments to Federal Reserve Board, Docket No. R-1343, Reg. E, submitted March 30, 2009.

funds fees for many Americans, banks have no incentive to change this practice absent strong oversight by bank regulators.

K. The regulators have failed to enforce the Truth In Savings Act requirement that banks provide account disclosures to prospective customers.

According to a 2008 GAO report[70] to Rep. Carolyn Maloney, then-chair of the Financial Institutions and Consumer Credit Subcommittee, based on a secret shopper investigation, banks don't give consumers access to the detailed schedule of account fee disclosures as required by the 1991 Truth In Savings Act. From GAO:

> Regulation DD, which implements the Truth in Savings Act (TISA), requires depository institutions to disclose (among other things) the amount of any fee that may be imposed in connection with an account and the conditions under which such fees are imposed. [. . .] GAO employees posed as consumers shopping for checking and savings accounts [. . .] Our visits to 185 branches of depository institutions nationwide suggest that consumers shopping for accounts may find it difficult to obtain account terms and conditions and disclosures of fees upon request prior to opening an account. Similarly, our review of the Web sites of the banks, thrifts, and credit unions we visited suggests that this information may also not be readily available on the Internet We were unable to obtain, upon request, a comprehensive list of all checking and savings account foes at 40 of the branches (22 percent) that we visited. [. . .] The results are consistent with those reported by a consumer group [U.S. PIRG] that conducted a similar exercise in 2001.

This, of course, keeps consumers from being able to shop around and compare prices. As cited by GAO, U.S. PIRG then complained of these concerns in a 2001 letter to then Federal Reserve Board Chairman Alan Greenspan.[71] No action was taken. The problem is exacerbated by a 2001 Congressional decision to eliminate consumers' private rights olfaction for Truth In Savings violations.

L. The Federal Reserve actively campaigned to eliminate a Congressional requirement that it publish an annual survey of bank account fees.

One of the consumer protections included in the 1989 savings and loan bailout law known as the Financial Institutions Reform, Recovery and Enforcement Act was Section 1002, which required the Federal Reserve to publish an annual report to Congress on fees and services of depository institutions. The Fed actively campaigned in opposition to the requirement and succeeded in convincing Congress to sunset the survey in 2003.[72] Most likely, the Fed was unhappy with the report's continued findings that each year bank fees increased, and that each year, bigger banks imposed the biggest fees.

SECTION 4. STRUCTURE AND JURISDICTION OF A CONSUMER FINANCIAL PROTECTION AGENCY

If the CFPA is to be effective in its mission, it must be structured so that it is strong and independent with full authority to protect consumers. Our organizations have strongly endorsed President Obama's proposal regarding what should be the agency's jurisdiction, responsibilities, rule-writing authority, enforcement powers and methods of funding.[73] His proposal would create a Consumer Financial Protection Agency (CFPA) with a broad jurisdiction over credit, savings and payment products, as well as fair lending and community reinvestment laws.[74] (Recommendations for improvement to the Administration bill are flagged below.) The legislation

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[70] "Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts", GAO-08-28I, January 2008, available at *http://www.gao.gov/new.items/d08281.pdf* (last visited 21 June 2009).

[71] The 1 November 2001 letter from Edmund Mierzwinski, U.S. PIRG, to Greenspan is available at *http://static.uspirg.org/reports/bigbanks2001/greenspanltr.pdf* (last visited 21 June 2009). In that letter, we also urged the regulators to extend Truth In Savings disclosure requirements to the Internet. No action was taken.

[72] The final 2003 report to Congress is available here *http://www.federalreserve.gov/boarddocs/rptcongress/2003fees.pdf* (last visited 21 June 2009). The 1997–2003 reports can all be accessed from this page, *http://www.federalreserve.gov/pubs/reports__other.htm* (last visited 21 June 2009).

[73] Senators Durbin, Schumer, Kennedy and Dodd offered the first legislative proposal to create a consumer financial agency (S. 566), known as the Financial Product Safety Commission. The bill was originally introduced in the last Congress.

[74] "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," Department of the Treasury, June 17, 2009, pp. 55–70. The White House has since proposed legislation to effectuate the proposal in this "White Paper."

has been introduced (without providing the agency jurisdiction over the Community Reinvestment Act) by House Financial Services Chairman Barney Frank as H.R. 3126.

In its work to protect consumers and the marketplace from abuses, the CFPA as envisioned by the Administration would have a full set of enforcement and analytical tools. The first tool would be that the CFPA could gather information about the marketplace so that the agency itself could understand the impact of emerging practices in the marketplace. The agency could use this information to improve the information that financial services companies must offer to customers about products, features or practices or to offer advice to consumers directly about the risk of a variety of products on the market. For some of these products, features or practices, the agency might determine that no regulatory intervention is warranted. For others, this information about the market will inform what tools are used. A second tool would be to address and rein in deceptive marketing practices or require improved disclosure of terms. The third tool would be the identification and regulatory facilitation of "plain-vanilla," low risk products that should be widely offered. The fourth tool would be to restrict or ban specific product features or terms that are harmful or not suitable in some circumstances, or that don't meet ordinary consumer expectations. Finally, the CFPA would also have the ability to prohibit dangerous financial products. We can only wonder how much less pain would have been caused for our economy if a regulatory agency had been actively exercising the latter two powers during the run up to the mortgage crisis.

A. Agency structure and jurisdiction.

Under the Administration's proposal, the agency would be governed by a five-member board. Four of these members would be appointed by the President and confirmed by the Senate. The final member would be the director of the consolidated bank supervisory agency proposed by the President. We strongly recommend that the stipulated qualifications for board membership be improved to require that board members have actual experience and expertise with consumer protection in the financial services arena. An agency focused solely on protecting consumers must be governed by leaders who have expertise not just in the financial services marketplace, but with protecting consumers in that marketplace.

The Administration proposes to have the agency oversee the sale and marketing of credit, deposit and payment products and services and related products and services, and will ensure that they are being offered in a fair, sustainable and transparent manner. This should include debit, prepaid debit, and stored value cards; loan servicing, collection, credit reporting and debt-related services (such as credit counseling, mortgage rescue plans and debt settlement) offered to consumers and small businesses. Our organizations support this jurisdiction because credit products can have different names and be offered by different types of entities, yet still compete for the same customers in the same marketplace. Putting the oversight of competing products under one set of minimum Federal rules regardless of who is offering that product will protect consumers, promote innovation, provide consumers with valuable options, and spur vigorous competition.

As with the Administration, we recommend against granting this agency jurisdiction over investment products that are marketed to retail investors, such as mutual funds. While there is a surface logic to this idea, we believe it is impractical and could inadvertently undermine investor protections. Giving the agency responsibility for investment products that is comparable to the proposed authority it would have over credit products would require the agency to add extensive additional staff with expertise that differs greatly from that required for oversight of credit products. Apparently simple matters, such as determining whether a mutual fund risk disclosure is appropriate or a fee is fair, are actually potentially quite complex and would require the new agency to duplicate expertise that already exists within the SEC. Moreover, it would not be possible simply to transfer the staff with that expertise to the new agency, since the SEC would continue to need that expertise on its own staff in order to fulfill its responsibilities for oversight of investment advisers and mutual fund operations. In addition, unless the new agency was given responsibility for all investment products and services a broker might recommend, brokers would be able to work around the new protections with potentially adverse consequences for investors. A broker who wanted to avoid the enhanced disclosures and restrictions required when selling a mutual fund, for example, could get around them by recommending a separately managed account. The investor would likely pay higher fees and receive fewer protections as a result. For these reasons, we believe the costs and risks of this proposal outweigh the potential benefits.

The Administration's plan wisely provides the agency with jurisdiction over a number of insurance products that are central or ancillary to credit transactions, in-

cluding credit, title, and mortgage insurance.[75] This principal behind this approach is to provide the agency with holistic jurisdiction over the entire credit transaction, including ancillary services often sold with or in connection with the credit. Additionally, there is ample evidence of significant consumer abuses in many of these lines of insurance, including low loss ratios, high mark ups, and "reverse competition" where the insurer competes for the business of the lender, rather than of the insurance consumer.[76] This Federal jurisdiction could apply without interfering with the licensing and rate oversight role of the States.

The United States has never sufficiently addressed the problems and challenges of lending discrimination and red lining practices, the vestiges of which include the present day unequal, two-tiered financial system that forces minority and low-income borrowers to pay more for financial services, get less value for their money, and exposes them to greater risk. It is therefore, imperative that the Consumer Financial Protection Agency also focus in a concentrated way on fair lending issues. To that end, the Agency must have a comprehensive Office of Civil Rights, which would ensure that no Federal agency perpetuated unfair practices and that no member of the financial industry practices business in a way that perpetuates discrimination. Compliance with civil rights statutes and regulations must be a priority at each Federal agency that has financial oversight or that enforces a civil rights statute. There must be effective civil rights enforcement of all segments of the financial industry. Moreover, each regulatory and enforcement agency must undertake sufficient reporting and monitoring activities to ensure transparency and hold the agencies accountable. A more detailed description of the civil rights functions that must be undertaken at the CFPA and at other regulatory and enforcement agencies can be found in the Civil Rights Policy Paper available at *www.ourfinancialsecurity.org.*[77]

B. Rule writing.

Under the Administration proposal, the agency will have broad rule-making authority to effectuate its purposes, including the flexibility to set standards that are adequate to address rapid evolution and changes in the marketplace. Such authority is not a threat to innovation, but rather levels the playing field and protects honest competition, as well as consumers and the economy.

The Administration's plan also provides that the rule-making authority for the existing consumer protection laws related to the provision of credit would be transferred to this agency, including the Truth in Lending Act (TILA), Truth in Savings Act (TISA), Home Ownership and Equity Protection Act (HOEPA), Real Estate Protection Act (RESPA), Fair Credit Reporting Act (FCRA), Electronic Fund Transfer Act (EFTA), and Fair Debt Collection Practices Act (FDCPA). Current rule-writing authority for nearly 20 existing laws is spread out among at least seven agencies. Some authority is exclusive, some joint, and some is concurrent. However, this hodgepodge of statutory authority has led to fractured and often ineffectual enforcement of these laws. It has also led to a situation where Federal rule-writing agencies may be looking at just part of a credit transaction when writing a rule, without considering how the various rules for different parts of the transaction affect the marketplace and the whole transaction. The CFPA with expertise, jurisdiction, and oversight that cuts across all segments of the financial products marketplace, will be better able to see inconsistencies, unnecessary redundancies, and ineffective regulations. As a marketwide regulator, it would also ensure that critical rules and regulations are not evaded or weakened as agencies compete for advantage for the entities they regulate.

Additionally the agency would have exclusive "organic" Federal rule-writing authority within its general jurisdiction to deem products, features, or practices unfair, deceptive, abusive or unsustainable, and otherwise to fulfill its mission and mandate. The rules may range from placing prohibitions, restrictions, or conditions on practices, products, or features to creating standards, and requiring special monitoring, reporting, and impact review of certain products, features, or practices.

C. Enforcement.

A critical element of a new consumer protection framework is ensuring that consumer protection laws are consistently and effectively enforced. As mentioned above, the current crisis occurred not only because of gaps and weaknesses in the law, but

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[75] The agency should also be given explicit authority over "forced-place" homeowner's insurance, which banks can require borrowers to purchase if they cannot procure their own coverage.

[76] Testimony of J. Robert Hunter, Director of Insurance, Consumer Federation of America, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the U.S. House Financial Services Committee, October 30, 2007, pp. 8–9.

[77] See *http://ourfinancialsecurity.org/issues/leveling-the-playing-field/*

primarily because the consumer protection laws that we do have were not always enforced. For regulatory reform to be successful, it must encourage compliance by ensuring that wrongdoers are held accountable.

A new CFPA will achieve accountability by relying on a three-legged stool: enforcement by the agency, by States, and by consumers themselves.

First, the CFPA itself will have the tools, the mission and the focus necessary to enforce its mandate. The CFPA will have a range of enforcement tools under the Administration proposal. The Administration, for example, would give the agency examination and primary compliance authority over consumer protection matters. This will allow the CFPA to look out for problems and address them in its supervisory capacity. But unlike the banking agencies, whose mission of looking out for safety and soundness led to an exclusive reliance on supervision, the CFPA will have no conflict of interest that prevents it from using its enforcement authority when appropriate. Under the Administration proposal, the agency will have the full range of enforcement powers, including subpoena authority; independent authority to enforce violations of the statues it administers; and civil penalty authority.

Second, both proposals allow States to enforce Federal consumer protection laws and the CFPA's rules. As Stated in detail in Section 5, States are often closer to emerging threats to consumers and the marketplace. They routinely receive consumer complaints and monitor local practices, which will permit State financial regulators to see violations first, spot local trends, and augment the CFPA's resources. The CFPA will have the authority to intervene in actions brought by States, but it can conserve its resources when appropriate. As we have seen in this crisis, States were often the first to act.

Finally, consumers themselves are an essential, in some ways the most essential, element of an enforcement regime. Recourse for individual consumers must, of course, be a key goal of a new consumer protection system. The Administration's plan appropriately States that the private enforcement provisions of existing statutes will not be disturbed.

A significant oversight of the Administration's plan is that it does not allow private enforcement of new CFPA rules. It is critical that the consumers who are harmed by violations of these rules be able to take action to protect themselves.

Consumers must have the ability to hold those who harm them accountable for numerous reasons:

- No matter how vigorous and how fully funded a new CFPA is, it will not be able to directly redress the vast majority of violations against individuals. The CFPA will likely have thousands of institutions within its jurisdiction. It cannot possibly examine, supervise or enforce compliance by all of them.
- Individuals have much more complete information about the affect of products and practices, and are in the best position to identify violations of laws, take action, and redress the harm they suffer. An agency on the outside looking in often will not have sufficient details to detect abusive behavior or to bring an enforcement action.
- Individuals are an early warning system that can alert States and the CFPA of problems when they first arise, before they become a national problem requiring the attention of a Federal agency. The CFPA can monitor individual actions and determine when it is necessary to step in.
- Bolstering public enforcement with private enforcement conserves public resources. A Federal agency cannot and should not go after every individual violation.
- Consumer enforcement is a safety net that ensures compliance and accountability after this crisis has passed, when good times return, and when it becomes more tempting for regulators to think that all is well and to take a lighter approach.
- The Administration's plan rightly identifies mandatory arbitration clauses as a barrier to fair adjudication and effective redress. We strongly agree—but it is also critically important regarding access to justice that consumers have the right to enforce a rule.

Private enforcement is the norm and has worked well as a complement to public enforcement in the vast majority of the consumer protection statutes that will be consolidated under the CFPA, including TILA, HOEPA, FDCPA, FCRA, EFTA and others.

Conversely, the statutes that lack private enforcement mechanisms are notable for the lack of compliance. The most obvious example is the prohibition against unfair and deceptive practices in Section 5 of the FTC Act. Though the banking agencies eventually identified unfair and deceptive mortgage and credit card practices

that should be prohibited (after vigorous congressional prodding), individuals were subject to those practices for years with no redress because they could not enforce the FTC Act. Not only consumers, but the entire economy and even financial institutions would have been much better off if consumers had been able to take action earlier on, when the abusive practices were just beginning.

D. Product evaluation, oversight, and monitoring.

Under the Administration's proposal, the agency would have significant enforcement and data collection authority to evaluate and to remove, restrict, or prevent unfair, deceptive, abusive, discriminatory, or unsustainable products, features or practices. The agency could also evaluate and promote practices, products, and features that facilitate responsible and affordable credit, payment devices, asset-building, and savings. Finally, the agency could assess the risks of both specific products and practices and overall market developments for the purpose of identifying, reducing and preventing excessive risk (*e.g.,* monitoring longitudinal performance of mortgages with certain features for excessive failure rates; and monitoring the market share of products and practices that present greater risks, such as weakening underwriting).

Specifically, we would recommend that the agency take the following approach to product evaluation, approval and monitoring under the proposal:

- Providers of covered products and services in some cases could be required to file adequate data and information to allow the agency to make a determination regarding the fairness, sustainability, and transparency of products, features, and practices. This could include data on product testing, risk modeling, credit performance over time, customer knowledge and behavior, target demographic populations, *etc.* Providers of products and services that are determined in advance to represent low risk would have to provide *de minimus* or no information to the agency.
- "Plain-vanilla" products, features or practices that are determined to be fair, transparent and sustainable would be determined to be presumptively in compliance and face less regulatory scrutiny and fewer restrictions.
- Products, features or practices that are determined to be potentially unfair, unsustainable, discriminatory, deceptive or too complex for its target population might be required to meet increased regulatory requirements and face increased enforcement and remedies.
- In limited cases, products, features or practices that are deemed to be particularly risky could face increased filing and data disclosure requirements, limited roll-out mandates, post-market evaluation requirements and, possibly, a stipulation of preapproval before they are allowed to enter or be used in the marketplace.
- The long-term performance of various types of products and features would be evaluated, and results made transparent and available broadly to the public, as well as to providers, Congress, and the media to facilitate informed choice.
- The Agency should hold periodic public hearings to examine products, practices and market developments to facilitate the above duties, including the adequacy of existing regulation and legislation, and the identification of both promising and risky market developments. These hearings would be especially important in examination of new market developments, such as, for example, where credit applications will soon be submitted via a mobile phone, for example, and consumer dependence on the Internet for conducting financial transactions is expected to grow dramatically. In such hearings, in rule-makings, and in other appropriate circumstances, the Agency should ensure that there is both opportunity and means for meaningful public input, including consideration of existing models such as funded public interveners.

E. Funding.

The Administration's proposal would authorize Congressional appropriations as needed for the agency. It also allows the agency to recover the amount of funds it spends through annual fees or assessments on financial services providers it oversees.

Our view is that the agency should have a stable (not volatile) funding base that is sufficient to support robust enforcement and is not subject to political manipulation by regulated entities. Funding from a variety of sources, as well as a mix of these sources, should be considered, including Congressional appropriations, user fees or industry assessments, filing fees, priced services (such as for compliance examinations) and transaction-based fees. See Appendix 4 for a comparison of current agency funding and fee structures.

None of these funding sources is without serious weaknesses. Industry assessments or user fees can provide the regulated entity with considerable leverage over the budget of the agency and facilitate regulatory capture of the agency, especially if the regulated party is granted any discretion over the amount of the assessment (or is allowed to decide who regulates them and shift its assessment to another agency.) Transaction-based fees can be volatile and unpredictable, especially during economic downturns. Filing fees can also decline significantly if economic activity falls. Congressional appropriations, as we have seen with other Federal consumer protection agencies over the last half-century, can be fairly easily targeted for reduction or restriction by well' funded special interests if these interests perceive that the agency has been too effective or aggressive in pursing its mission.

If an industry-based funding method is used, it should ensure that all providers of covered products and services are contributing equally based on their size and the nature of the products they offer. A primary consideration in designing any industry-based funding structure is that certain elements of these sectors should not be able to evade the full funding requirement, through charter shopping or other means. If such requirements can be met, we would recommend a blended funding structure from multiple sources that requires regulated entities to fund the baseline budget of the agency and Congressional appropriations to supplement this budget if the agency demonstrates an unexpected or unusual demand for its services.

F. Consumer complaints.

The Administration proposal would require the agency to collect and track federally directed complaints rewarding credit or payment products, features, or practices under the agency's jurisdiction.[78] This is a very important function but it should be improved in two significant respects. First, the agency should also be charged with resolving consumer complaints. Existing agencies, particularly the OCC, have generally not performed this function well.[79] Secondly, the agency should be designated as the sole repository of consumer complaints on products, features, or practices within its jurisdiction, and should ensure that this is a role that is readily visible to consumers, simple to access and responsive. The agency should also be required to conduct real-time analysis of consumer complaints regarding patterns and practices in the credit and payment systems industries and to apply these analyses when writing rules and enforcing rules and laws.

G. Federal preemption of State laws.

As the Administration proposal States, the agency should establish minimum standards within its jurisdictions. CFPA rules would preempt weaker State laws, but States that choose to exceed the standards established by the CFPA could do so. The agency's rules would preempt statutory State law only when it is impossible to comply with both State and Federal law.

We also strongly agree with the Administration's recommendation that federally chartered institutions be subject to nondiscriminatory State consumer protection and civil rights laws to the same extent as other financial institutions. A clear lesson of the financial crisis, which pervades the Administration's plan, is that protections should apply consistently across the board, based on the product or service that is being offered, not who is offering it.

Restoring the viability of our background State consumer protection laws is also essential to the flexibility and accountability of the system in the long run. The specific rules issued by the CFPA and the specific statutes enacted by Congress will never be able to anticipate every innovative abuse designed to avoid those rules and statutes. The fundamental State consumer protection laws, both statutory and common law, against unfair and deceptive practices, fraud, good faith and fair dealing, and other basic, longstanding legal rules are the ones that spring up to protect consumers when a new abuse surfaces that falls within the cracks of more specific laws. We discuss preemption in greater detail in the next section.

H. Other aspects of the Administration proposal.

As discussed briefly above, the CFPA should also have the authority to grant intervener funding to consumer organizations to fund expert participation in its stakeholder activities. The model has been used successfully to fund consumer group par-

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[78] The CFPA should have responsibility for collecting and tracking complaints about consumer financial services and facilitating complaint resolution with respect to federally supervised institutions. Other Federal supervisory agencies should refer any complaints they receive on consumer issues to the CFPA; complaint data should be shared across agencies . . . , "A New Foundation", pp. 59–60, The Obama Administration, June 2009.

[79] Travis Plunkett testimony, July 2007 "Improving Federal Consumer Protections in Financial Services", p. 10.

ticipation in State utility rate making. Second, a Government chartered consumer organization should be created by Congress to represent consumers' financial services interests before regulatory, legislative, and judicial bodies, including before the CFPA. This organization could be financed through voluntary user fees such as a consumer check-off included in the monthly Statements financial firms send to their customers. It would be charged with giving consumers, depositors, small investors and taxpayers their own financial reform organization to counter the power of the financial sector, and to participate fully in rulemakings, adjudications, and lobbying and other activities now dominated by the financial lobby.[80]

Moreover, we recommend that the Administration's proposal deal more explicitly with incentives that are paid to and whistleblower protections that are provided to employees working in the credit sector. An incentive system similar to one at the top is at work at the street level of the biggest banks. In the tens of thousands of bank branches and call centers of our biggest banks, employees-including bank tellers earning an average of $11.32 an hour-are forced to meet sales goals to keep their jobs and earn bonuses. Many goals for employees selling high-fee and high-interest products like credit cards and checking accounts have actually gone up as the economy has gone down.

Risk-taking in the industry will quickly outpace regulatory coverage unless financial sector employees can challenge bad practices as they develop and direct regulators to problems. Whistleblowers are critical to combating fraud and other institutional misconduct. The Federal Government needs to hear from and protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare. If we previously had more protections for whistleblowers, we would have had more warning of the eventual collapse of Wall Street.

Since 2000, Congress has enacted or strengthened whistleblower protections in six laws. They include consumer product manufacturing and retail commerce, railroads, the trucking industry, metropolitan transit systems, defense contractors, and all entities receiving stimulus funds. All of these laws provide more incentives and protections for disclosure of wrongdoing than does the current proposal from the Administration. For example, it does not protect disclosures made to an employer, which is often the first action taken by loyal, concerned employees, and the impetus for retaliation. Also conspicuously absent are administrative procedures and remedies that include best practices for fair and adequate consideration of claims by employees.

We recommend the following improvements in any reform legislation before the Committee.

Whistleblower protections. Innovation in the industry will quickly outpace regulatory coverage unless bank branch, call-center, and other financial sector employees can challenge bad practices as they develop and direct regulators to problems. The Federal Government needs to hear from and provide best practice whistleblower rights consistent with those in the stimulus and five laws passed or strengthened last Congress to protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare.

Fair compensation. New rules need to restructure pay and incentives for front-line finance sector employees away from the current "sell-anything" culture. The hundreds of thousands of front-line workers who work under pressure of sales goals need to be able to negotiate sensible compensation policies that reward service and sound banking over short-term sales.

SECTION 5. REBUTTAL TO ARGUMENTS AGAINST THE CFPA

Proactive, affirmative consumer protection is essential to modernizing financial system oversight and to reducing risk. The current crisis illustrates the high costs of a failure to provide effective consumer protection. The complex financial instruments that sparked the financial crisis were based on home loans that were poorly underwritten; unsuitable to the borrower; arranged by persons not bound to act in the best interest of the borrower; or contained terms so complex that many individual homeowners had little opportunity to fully understand the nature or magnitude of the risks of these loans. The crisis was magnified by highly leveraged, largely unregulated financial instruments and inadequate risk management.

Opponents of reform of the financial system have made several arguments against the establishment of a strong independent Consumer Financial Protection Agency. Indeed, the new CFPA appears to be among their main targets for criticism, compared with other elements of the reform plan. They have basically made six arguments. They have argued that regulators already have the powers it would be given,

[80] As his last legislative activity, in October 2002, Senator Paul Wellstone proposed establishment of such an organization, the Consumer and Shareholder Protection Association, S 3143.

that it would be a redundant layer of bureaucracy, that consumer protection cannot be separated from supervision, that it will stifle innovation, that it would be unfair to small institutions and that its anti-preemption provision would lead to balkanization. Each of these arguments is fatally flawed:

A. Opponents argue that regulators already have the powers that the CFPA would be given.

This argument is effectively a defense of the *status quo,* which has led to disastrous results. Current regulators already have between them some of the powers that the new agency would be given, but they haven't used them. Conflicts of interest and missions and a lack of will have worked against consumer enforcement. While our section above goes into greater detail on the failures of the regulators, two examples will illustrate:

- *No HOEPA Rules Until 2008:* The Federal Reserve Board was granted sweeping antipredatory mortgage regulatory authority by the 1994 Home Ownership and Equity Protection Act (HOEPA). Final regulations were issued on 30 July 2008 only after the world economy had collapsed due to the collapse of the U.S. housing market triggered by predatory lending.[81]
- *No Action on Abusive Credit Card Practices Until Late 2008:* Further, between 1995 and 2007, the Office of the Comptroller of Currency issued only one public enforcement action against a Top Ten credit card bank (and then only after the San Francisco District Attorney had brought an enforcement action) and only one other public enforcement order against a mortgage subsidiary of a large national bank (only after HUD initiated action). In that period, "the OCC has not issued a public enforcement order against any of the eight largest national banks for violating consumer lending laws."[82] The OCC's failure to act on rising credit card complaints at the largest national banks triggered Congress to investigate, resulting in passage of the 2009 Credit Card Accountability, Responsibility and Disclosure Act (CARD Act).[83] While that law was under consideration, other Federal regulators used their authority under the Federal Trade Commission Act to propose and finalize a similar rule.[84] By contrast, the OCC requested the addition of two significant loopholes to a key protection of the proposed rule.

Federal bank regulators currently face at least two conflicts. First, their primary mission is prudential supervision, with enforcement of consumer laws taking a back seat. Second, charter shopping in combination with agency funding by regulated entities encourages a regulatory race to the bottom as banks choose the regulator of least resistance. In particular, the Office of the Comptroller of the Currency and the Office of Thrift Supervision have failed utterly to protect consumers, let alone the safety and soundness of regulated entities. Instead, they competed with each other to minimize consumer protection standards as a way of attracting institutions to their charters, which meant that they tied their own hands and failed to fulfill their missions. (Note: they weren't trying to fail, but that was a critical side effect of the charter competition.)

Establishing a new consumer agency that has consumer protection as its only mission and that regulated firms cannot hide from by charter-shopping is the best way to guarantee that consumer laws will receive sustained, thoughtful, proactive attention from a Federal regulator.

B. Opponents argue that the CFPA would be a redundant layer of bureaucracy.

> We do not propose a new regulatory agency because we seek more regulation, but because we seek better regulation. The very existence of an agency devoted to consumer protection in financial services will be a strong incentive for institutions to develop strong cultures of consumer protection. (The Obama Administration, *Financial Regulatory Reform: A New Foundation,* p. 57)

The new CFPA would not be a redundant layer of bureaucracy. To the contrary, the new agency would consolidate and streamline Federal consumer protection for credit, savings and payment products that is now required in almost 20 different

[81] 73 FR 147, Page 44522, Final HOEPA Rule, 30 July 2008.

[82] Testimony of Professor Arthur Wilmarth, 26 April 2007, before the Subcommittee on Financial Institutions and Consumer Credit, hearing on Credit Card Practices: Current Consumer and Regulatory Issues *http://www.house.gov/financialservices/hearing110/htwilmarth042607.pdf.*

[83] H.R. 627 was signed into law by President Obama as Pub. L. No. 111-24 on 22 May 2009.

[84] The final rule was published in the Federal Register a month later. 74 FR 18, p. 5498 Thursday, January 29, 2009.

statutes and divided between seven different agencies. As the New Foundation document continues:

> The core of such an agency can be assembled reasonably quickly from discrete operations of other agencies. Most rule-writing authority is concentrated in a single division of the Federal Reserve, and three of the four Federal banking agencies have mostly or entirely separated consumer compliance supervision from prudential supervision. Combining staff from different agencies is not simple, to be sure, but it will bring significant benefits for responsible consumers and institutions, as well as for the market for consumer financial services and products.[85]

And today, a single transaction such as a mortgage loan is subject to regulations promulgated by several agencies and may be made or arranged by an entity supervised by any of several other agencies. Under the CFPA, one Federal agency will write the rules and see that they are followed.

C. Opponents argue that consumer protection cannot be separated from supervision.

The current regulatory consolidation of both of these functions has led to the subjugation of consumer protection in most cases, to the great harm of Americans and the economy. Nevertheless, trade associations for many of the financial institutions that have inflicted this harm claim that a new approach that puts consumer protection at the center of financial regulatory efforts will not work. The American Bankers Association, for example, States that while the length of time banks hold checks under Regulation CC may be a consumer issue, "fraud and payments systems operational issues" are not.[86]

Again, as the Administration points out in its carefully thought-out blueprint for the new agency:

> The CFPA would be required to consult with other Federal regulators to promote consistency with prudential, market, and systemic objectives. Our proposal to allocate one of the CFPA's five board seats to a prudential regulator would facilitate appropriate coordination.[87]

We concur that the new agency should have full rulemaking authority over all consumer statutes. The checks and balances proposed by the Administration, including the consultative requirement and the placement of a prudential regulator on its board and its requirement to share confidential examination reports with the prudential regulators will address these concerns. In addition, the Administration's plan provides the CFPA with full compliance authority to examine and evaluate the impact of any proposed consumer protection measure on the bottom line of affected financial institutions. While collaboration between regulators will be very important, it should not be used as an excuse by either the CFPA or other regulators to unnecessarily delay needed action. The GAO, for example, has identified time delays in interagency processes as a contributor to the mortgage crisis.[88] This is why it is important that the CFPA retain final rulemaking authority, as proposed under the Administration's plan. Such authority, along with the above mentioned mandates, will ensure that both the CFPA and the Federal prudential regulator collaborate on a timely basis.

For most of the last 20 years, bank regulators have shown little understanding of consumer protection and have not used powers they have long held. OCC's traditional focus and experience has been on safety and soundness, rather than consumer protection.[89] Its record on consumer protection enforcement is one of little experience and little evidence of expertise. In contrast, as already noted, the States have long experience in enforcement of non-preempted State consumer protection laws. OCC admits that it was not until 2000 that it invoked long-dormant consumer pro-

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[85] The Obama Administration, "Financial Regulatory Reform: A New Foundation", p. 57.

[86] Letter of 28 May 2009 from the American Bankers Association to Treasury Secretary Tim Geithner, available at *http://www.aba.com/NR/rdonlyres/4640E4F1-4BC9-4187-B9A6-E3705DD9B307/60161/GeithnerMay282009.pdf* (last viewed 21 June 2009).

[87] The Obama Administration, Financial Regulatory Reform: A New Foundation, p. 59.

[88] "As we note in our report, efforts by regulators to respond to the increased risks associated with the new mortgage products were sometimes slowed in part because of the need for five Federal regulators to coordinate their response." "Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System", Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, February 4, 2009, pp. 15–16.

[89] See Christopher L. Peterson, "Federalism and Predatory Lending: Unmasking the Deregulatory Agenda", 78 Temp. L. Rev. 1, 73 (2005).

tection authority provided by the 1975 amendments to the Federal Trade Commission Act.[90]

D. Opponents argue that a single agency focused on consumer protection will "stifle innovation" in the financial services marketplace.

To the contrary, protecting consumers from traps and tricks when they purchase credit, savings or payment products should encourage confidence in the financial services marketplace and spur innovation. As Nobel Laureate Joseph Stiglitz has said:

> There will be those who argue that this regulatory regime will stifle innovation. However, a disproportionate part of the innovations in our financial system have been aimed at tax, regulatory, and accounting arbitrage. They did not produce innovations which would have helped our economy manage some critical risks better-like the risk of home ownership. In fact, their innovations made things worse. I believe that a well-designed regulatory system, along the lines I've mentioned, will be more competitive and more innovative-with more of the innovative effort directed at innovations which will enhance the productivity of our firms and the well-being, including the economic security, of our citizens.[91]

E. Opponents argue that the CFPA would place an unfair regulatory burden on small banks and thrifts.

Small banks and thrifts that offer responsible credit and payment products should face a lower regulatory burden under regulation by a CFPA. Members of Congress, the media and consumer organizations have properly focused on the role of large, national banks and thrifts in using unsustainable, unfair and deceptive mortgage and credit card lending practices. In contrast, many smaller banks and thrifts have justifiably been praised for their more responsible lending practices in theses areas. In such situations, the CFPA would promote fewer restrictions and less oversight for "plain-vanilla" products that are simple, straightforward and fair.

However, it is also important to note that some smaller hanks and thrifts have, unfortunately, been on the cutting edge of a number of other abusive lending practices that are harmful to consumers and that must be addressed by a CFPA. More than 75 percent of State chartered banks surveyed by the FDIC, for example, automatically enrolled customers in high-cost overdraft loan programs without consumers' consent. Some of these banks deny consumers the ability to even opt out of being charged high fees for overdraft transactions that the banks chose to permit. Smaller banks have also been leaders in facilitating high-cost refund anticipation loans, in helping payday lenders to evade State loan restrictions and in offering deceptive and extraordinarily expensive "fee harvester" credit cards. (See Appendix 1 for more information.)

F. Opponents argue that the agency's authority to establish only a Federal floor of consumer protection would lead to regulatory inefficiency and balkanization.

The loudest opposition to the new agency will likely be aimed at the Administration's sensible proposal that CFPA's rules be a Federal floor and that the States be allowed to enact stronger consumer laws that are not inconsistent, as well as to enforce both Federal and State laws. This proposed return to common sense protections is strongly endorsed by consumer advocates and State attorneys general.

We expect the banks and other opponents to claim that the result will be 51 balkanized laws that place undue costs on financial institutions that are then passed onto consumers in the form of higher priced or less available loans. In fact, this approach is likely to lead to a high degree of regulatory uniformity (if the CFPA sets high minimum standards,) greater protections for consumers without a significant impact on cost or availability, increased public confidence in the credit markets and financial institutions, and less economic volatility. For example, comprehensive research by the Center for Responsible Lending found that subprime mortgage loans in States that acted vigorously to rein in predatory mortgage lending before they were preempted by the OCC had fewer abusive terms. In States with stronger pro-

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[90] See Julie L. Williams and Michael L. Bylsma, "On the Same Page: Federal Banking Agency Enforcement of the FTC Act To Address Unfair and Deceptive Practices by Banks", 58 Bus. Law. 1243, 1244, 1246 and n. 25, 1253 (2003) (citing authority from the early 1970s indicating that OCC had the authority to bring such an action under Section 8 of the Federal Deposit Insurance Act, noting that OCC brought its first such case in 2000, and conceding that "[a]n obvious question is why it took the Federal banking agencies more than 25 years to reach consensus on their authority to enforce the FTC Act").

[91] "Too Big to Fail or Too Big to Save? Examining the Systemic Threats of Large Financial Institutions", Joseph E. Stiglitz, April 21, 2009, p. 10.

tections, interest rates on subprime mortgages did not increase, and instead, sometimes decreased, without reducing the availability of these loans.[92] Additionally, as Nobel Laureate Joseph Stiglitz has pointed out, the cost of regulatory duplication is miniscule to the cost of the regulatory failure that has occurred.[93]

It is also clear that the long campaign of preemption by the OTS and OCC, culminating in the 2004 OCC rules, contributed greatly to the current predatory lending crisis. After a discussion of the OCC's action eliminating State authority, we will discuss more generally why Federal consumer law should always be a floor.

F.1. The OCC's Preemption of State Laws Exacerbated The Crisis. In 2000–2004, the OCC worked with increasing aggressiveness to prevent the States from enforcing State laws and stronger State consumer protection standards against national banks and their operating subsidiaries, from investigating or monitoring national banks and their operating subsidiaries, and from seeking relief for consumers from national banks and subsidiaries.

These efforts began with interpretative letters stopping State enforcement and State standards in the period up to 2004, followed by OCC's wide-ranging preemption regulations in 2004 purporting to interpret the National Bank Act, plus briefs in court cases supporting national banks' efforts to block State consumer protections.

In a letter to banks on November 25, 2002, the OCC openly instructed banks that they "should contact the OCC in situations where a State official seeks to assert supervisory authority or enforcement jurisdiction over the bank . . . .[94] The banks apparently accepted this invitation, notifying the OCC of State efforts to investigate or enforce State laws. The OCC responded with letters to banks and to State banking agencies asserting that the States had no authority to enforce State laws against national banks and subsidiaries, and that the banks need not comply with the State laws.[95]

For example, the OCC responded to National City Bank of Indiana, and its operating subsidiaries, National City Mortgage Company, First Franklin Financial Corporation, and Altegra Credit Company, regarding Ohio's authority to monitor their mortgage banking and servicing businesses. That opinion concluded that "the OCC's exclusive visitorial powers preclude States from asserting supervisory authority or enforcement jurisdiction over the Subsidiaries."[96]

The OCC responded to Bank of America, N.A., and its operating subsidiary, BA Mortgage LLC, regarding California's authority to examine the operating subsidiary's mortgage banking and servicing businesses and whether the operating subsidiary was required to maintain a license under the California Residential Mortgage Lending Act. That opinion concluded that "the Operating Subsidiary also is not subject to State or local licensing requirements and is not required to obtain a license from the State of California in order to conduct business in that State."[97]

The OCC wrote the Pennsylvania Department of Banking, stating that Pennsylvania does not have the authority to supervise an unnamed national bank's unnamed operating subsidiary which engages in subprime mortgage lending.[98] (The

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[92] Wei Li and Keith S. Ernst, Center for Responsible Lending, "The Best Value in the Subprime Market: State Predatory Lending Reforms", February, 23, 2006, p. 6.

[93] "Some worry about the cost of duplication. But when we compare the cost of duplication to the cost of damage from inadequate regulation—not just the cost to the taxpayer of the bailouts but also the costs to the economy from the fact that we will be performing well below our potential—it is clear that there is not comparison," Testimony of Dr. Joseph E. Stiglitz, Professor, Columbia University, before the House Financial Services Committee, October 21, 2008, p. 16.

[94] Office of the Comptroller of the Currency, Interpretive Letter No. 957 n.2 (Jan. 27, 2003) (citing OCC Advisory Letter 2002-9 (Nov. 25, 2002)) (viewed Jun. 19, 2009, at *http://www.occ.treas.gov/interp/mar03/int957.doc,* and available at 2003 OCC Ltr. LEXIS 11).

[95] *E.g.,* Office of the Comptroller of the Currency, Interpretive Letter No. 971 (Jan. 16, 2003) (letter to Pennsylvania Department of Banking, that it does not have the authority to supervise an unnamed national bank's unnamed operating subsidiary which engages in subprime mortgage lending (unnamed because the interpretive letter is unpublished) (viewed Jun. 19, 2009, at *http://comptrollerofthecurrency.gov/interp/sep03/int971.doc,* and available at 2003 OCC QJ LEXIS 107).

[96] Office of the Comptroller of the Currency, Interpretive Letter No. 958 (Jan. 27, 2003) (viewed Jun. 19, 2009, at *http://www.occ.treas.gov/interp/mar03/int958.pdf,* and available at 2003 OCC Ltr. LEXIS 10).

[97] The OCC's exclusive visitorial powers preclude States from asserting supervisory authority or enforcement jurisdiction over the Subsidiaries (Jan. 27, 2003) (viewed Jun. 19, 2009, at *http://www.occ.treas.gov/interp/mar03/int957.doc*), and available at 2003 OCC Ltr. LEXIS 11).

[98] Office of the Comptroller of the Currency, Interpretive Letter No. 971 (unpublished) (Jan. 16, 2003) (viewed Jun. 19, 2009, at *http://comptrollerofthecurrency.gov/interp/sep03/int971.doc,* and available at 2003 OCC QJ LEXIS 107).

national bank and operating subsidiary were not named because this interpretive letter was unpublished.)

The OCC even issued a formal preemption determination and order, stating that "the provisions of the GFLA [Georgia Fair Lending Act] affecting national banks' real estate lending are preempted by Federal law" and "issuing an order providing that the GFLA does not apply to National City or to any other national bank or national bank operating subsidiary that engages in real estate lending activities in Georgia."[99]

As Business Week pointed out in 2003, not only did States attempt to pass laws to stop predatory lending, they also attempted to warn Federal regulators that the problem was getting worse.[100]

A number of factors contributed to the mortgage disaster and credit crunch. Interest rate cuts and unprecedented foreign capital infusion fueled thoughtless lending on Main Street and arrogant gambling on Wall Street. The trading of esoteric derivatives amplified risks it was supposed to mute. One cause, though, has been largely overlooked: the stifling of prescient State enforcers and legislators who tried to contain the greed and foolishness. They were thwarted in many cases by Washington officials hostile to regulation and a financial industry adept at exploiting this ideology.

Under the proposal, critical authority will be returned to those attorneys general, who have demonstrated both the capacity and the will to enforce consumer laws. In addition to losing the States' experience in enforcing such matters, depriving the States of the right to enforce their non-preempted consumer protection laws raises serious concerns of capacity. According to a recent congressional report, State banking agencies and State attorneys general offices employ nearly 700 full time staff to monitor compliance with consumer laws, more than 17 times the number of OCC personnel then allocated to investigate consumer complaints.[101]

Earlier this year, Illinois Attorney General Lisa Madigan testified before this Committee and outlined the numerous major, multistate cases against predatory lending that have been brought by her office and other State offices of attorneys general. However, she included this caveat:

> State enforcement actions have been hamstrung by the dual forces of preemption of State authority and lack of Federal oversight. The authority of State attorneys general to enforce consumer protection laws of general applicability was challenged at precisely the time it was most needed—when the amount of sub prime lending exploded and riskier and riskier mortgage products came into the marketplace.[102]

This month, General Madigan and seven colleagues sent President Obama a letter supporting a Consumer Financial Protection Agency preserving State enforcement authority:

> [W]e believe that any reform must (1) preserve State enforcement authority, (2) place Federal consumer protection powers with an agency that is focused primarily on consumer protection, and (3) place primary oversight with Government agencies and not depend on industry selfregulation.[103]

F.2. Why Federal Law Should Always Be a Floor. Consumers need State laws to prevent and solve consumer problems. State legislators generally have smaller districts than members of Congress do. State legislators are closer to the needs of their constituents than members of Congress. States often act sooner than Congress on new consumer problems. Unlike Congress, a State legislature may act before a harmful practice becomes entrenched nationwide. In a September 22, 2003, speech

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[99] Office of the Comptroller of the Currency, Preemption Determination and Order, 68 Fed. Reg. 46,264, 46,264 (Aug. 5, 2003).

[100] Robert Berner and Brian Grow, "They Warned Us About the Mortgage Crisis", *Business Week,* 9 October 2008, available at *http://www.businessweek.com/magazine/content/08_42/b4104036827981.htm,* (last visited 21 June 2009).

[101] See H. Comm. on Financial Services, 108th Cong., Views and Estimates on Matters To Be Set Forth in the Concurrent Resolution on the Budget for Fiscal Year 2005, at 16 (Comm. Print 2004). "In the area of abusive mortgage lending practices alone, State bank supervisory agencies initiated 20,332 investigations in 2003 in response to consumer complaints, which resulted in 4,035 enforcement actions."

[102] Testimony of Illinois Attorney General Lisa Madigan Before the Committee on Financial Services, Hearing on Federal and State Enforcement of Financial Consumer and Investor Protection Laws, 20 March 2009, available at *http://www.house.gov/apps/list/hearing/financialsvcs_dem/il_-_madigan.pdf* (last visited 22 June 2009).

[103] Letter of 15 June 2009, from the chief legal enforcement officers of eight States (California, Connecticut, Illinois, Iowa, Maryland, Massachusetts, North Carolina, and Ohio) to President Obama, on file with the authors.

to the American Bankers Association in Hawaii, Comptroller John D. Hawke admitted that consumer protection activities "are virtually always responsive to real abuses." He continued by pointing out that Congress moves slowly. Comptroller Hawke said, "It is generally quite unusual for Congress to move quickly on regulatory legislation—the Gramm-Leach-Bliley privacy provisions being a major exception. Most often they respond only when there is evidence of some persistent abuse in the marketplace over a long period of time." U.S. consumers should not have to wait for a persistent, nationwide abuse by banks before a remedy or a preventative law can be passed and enforced by a State to protect them.

States can and do act more quickly than Congress, and States can and do respond to emerging practices that can harm consumers while those practices are still regional, before they spread nationwide. These examples extend far beyond the financial services marketplace.

States and even local jurisdictions have long been the laboratories for innovative public policy, particularly in the realm of environmental and consumer protection. The Federal Clean Air Act grew out of a growing State and municipal movement to enact air pollution control measures. The national organic labeling law, enacted in October 2002, was passed only after several States, including Oregon, Washington, Texas, Idaho, California, and Colorado, passed their own laws. In 1982, Arizona enacted the first "Motor Voter" law to allow citizens to register to vote when applying for or renewing drivers' licenses; Colorado placed the issue on the ballot, passing its Motor Voter law in 1984. National legislation followed suit in 1993. Cities and counties have long led the smoke-free indoor air movement, prompting States to begin acting, while Congress, until this month, proved itself virtually incapable of adequately regulating the tobacco industry. A recent and highly successful FTC program—the National Do Not Call Registry to which 58 million consumers have added their names in 1 year—had already been enacted in 40 States.

But in the area of financial services, where State preemption has arguably been the harshest and most sweeping, examples of innovative State activity are still numerous. In the past 5 years, since the OCC's preemption regulations have blocked most State consumer protections from application to national banks, one area illustrating the power of State innovation has been in identity theft, where the States have developed important new consumer protections that are not directed primarily at banking. In the area of identity theft, States are taking actions based on a nonpreemptive section of the Fair Credit Reporting Act, where they still have the authority to act against other actors than national banks or their subsidiaries.

There are 7 to 10 million victims of identity theft in the U.S. every year, yet Congress did not enact modest protections such as a security alert and a consumer block on credit report information generated by a thief until passage of the Fair and Accurate Credit Transactions Act (FACT Act or FACTA) in 2003. That law adopted just some of the identity theft protections that had already been enacted in States such as California, Connecticut, Louisiana, Texas, and Virginia.[104]

Additionally FACTA's centerpiece protection against both inaccuracies and identity theft, access to a free credit report annually on request, had already been adopted by seven States: Colorado, Georgia, Maine, Maryland, Massachusetts, New Jersey, and Vermont. Further, California in 2000, following a joint campaign by consumer groups and realtors, became the first State to prohibit contractual restrictions on realtors showing consumers their credit scores, ending a decade of stalling by Congress and the FTC.[105] The FACT act extended this provision nationwide.

Yet, despite these provisions, advocates knew that the 2003 Federal FACTA law would not solve all identity theft problems. Following strenuous opposition by consumer advocates to the blanket preemption routinely sought by industry as a condition of all remedial Federal financial legislation, the final 2003 FACT Act continued to allow States to take additional actions to prevent identity theft. The results have been significant.

Since its passage, fully 47 States and the District of Columbia have granted consumers the right to prevent access to their credit reports by identity thieves through a security freeze. Indeed, even the credit bureaus, longtime opponents of the freeze, then adopted the freeze nationwide.[106]

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[104] See California Civil Code §§1785.11.1, 1785.11.2, 1785,16.1; Conn. SB 688 §9(d), (e), Conn. Gen. Stats. §36a-699; IL Re. Stat. Ch. 505 §2MM; LA Rev. Stat. §§9:3568B.1, 9:3568C, 9:3568D, 9:3571.1 (H)-(L); Tex. Bus. & Comm. Code §§20.01(7), 20.031, 20.034-039, 20.04; VA Code §§18.2-186.31 :E.

[105] See 2000 Cal. Legis. Serv. 978 (West). This session law was authored by State Senator Liz Figueroa. "An act to amend Sections 1785.10, 1785.15, and 1785.16 of, and to add Sections 1785.15.1, 1785.15.2, and 1785.20.2 to the Civil Code, relating to consumer credit."

[106] Consumers Union, U.S. PIRG and AARP cooperated on a model State security freeze proposal that helped ensure that the State laws were not balkanized, but converged toward a com-

A key principle of federalism is the role of the States as laboratories for the development of law.[107] State and Federal consumer protection laws can develop in tandem. After one or a few States legislate in an area, the record and the solutions developed in those States provide important information for Congress to use in deciding whether to adopt a national law, how to craft such a law, and whether or not any new national law should displace State law.

A few more examples from California illustrate the important role of the States as a laboratory and a catalyst for Federal consumer protections for bank customers. In 1986, California required that specific information be included in credit card solicitations with enactment of the then-titled Areias-Robbins Credit Card Full Disclosure Act of 1986. That statute required every credit card solicitation to contain a chart showing the interest rate, grace period, and annual fee.[108] Two years later, Congress chose to adopt the same concept in the Federal Fair Credit and Charge Card Disclosure Act (FCCCDA), setting standards for credit card solicitations, applications and renewals.[109] The 1989 Federal disclosure box[110] (know as the "Schumer Box") is strikingly similar to the disclosure form required under the 1986 California law.

States also led the way in protecting financial services consumers from long holds on deposited checks. California enacted restrictions on the length of time a bank could hold funds deposited by a consumer in 1983; Congress followed in 1986. California's 1983 funds availability statute required the California Superintendent of Banks, Savings and Loan Commissioner, and Commissioner of Corporations to issue regulations to define a reasonable time after which a consumer must be able to withdraw funds from an item deposited in the consumer's account.[111] Similar laws were passed in Massachusetts, New York, New Jersey, and other States. Congress followed a few years later with the Federal Expedited Funds Availability Act of 1986.[112] California led the way on security breach notice legislation. Its law and those of other States have functioned as a *de facto* national security breach law, while Congress has failed to act.[113]

It is certainly not the case that States always provide effective consumer protection. The States have also been the scene of some notable regulatory breakdowns in recent years, such as the failure of some States to properly regulate mortgage brokers and nonbank lenders operating in the subprime lending market, and the inability or unwillingness of many States to rein in lenders that offer extraordinarily high-cost, short term loans and trap consumers in an unsustainable cycle of debt, such as payday lenders and auto title loan companies. Conversely, Federal lawmakers have had some notable successes in providing a high level of financial services consumer protections in the last decade, such as the Credit Repair Organizations Act and the recently enacted Military Lending Act.[114] This is why it is necessary for this new Federal agency to ensure that a minimum level of consumer protection is established in all States.

Nonetheless, as these examples show, State law is an important source of ideas for future Federal consumer protections. As Justice Brandeis said in his dissent in New State Ice Co., "Denial of the right [of States] to experiment may be fraught with serious consequences to the Nation" (285 U.S. at 311). A State law will not serve this purpose if States cannot apply their laws to national banks, who are big players in the marketplace for credit and banking services. State lawmakers simply won't pass new consumer protection laws that do not apply to the largest players in the banking marketplace.

Efficient Federal public policy is one that is balanced at the point where even though the States have the authority to act, they feel no need to do so. Since we cannot guarantee that we are ever at that optimum, setting Federal law as a floor of protection as the default—without also preempting the States—allows us to re-

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mon standard. More information on the State security freeze laws is available at *http://www.consumersunion.org/campaigns/learn_more/003484indiv.html* (last visited 21 June 2009).

[107] *New State Ice Co. v. Leibman,* 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

[108] 1986 Cal. Stats., Ch. 1397, codified at California Civil Code §1748.11.

[109] Pub. L. 100-583, 102 Stat. 2960 (Nov. 1, 1988), codified in part at 15 U.S.C. §§1637(c) and 1610(e).

[110] 54 Fed. Reg. 13855 (April 6, 1989, Appendix G, form G-10(B)).

[111] 1983 Cal. Stat. Ch. 1011, §2, codified at Cal. Fin. Code §866.5.

[112] Pub. L. 100-86, Aug. 10, 1987, 101 Stat. 552, 635, codified at 12 U.S.C. §4001.

[113] More information on State security breach notice laws is available at *http://www.consumersunion.org/campaigns/financialprivacynow/002215indiv.html* (last visited 21 June 2009).

[114] Military Lending Act, 10 U.S.C. §987. Credit Repair Organizations Act, 15 U.S.C. §1679h (giving State Attorneys General and FTC concurrent enforcement authority).

tain the safety net of State–Federal competition to guarantee the best public policy. [115]

Conclusion

As detailed above, a strong Federal commitment to robust consumer protection is central to restoring and maintaining a sound economy. The Nation's financial crisis grew out of the proliferation of inappropriate and unsustainable lending practices that could have and should have been prevented. That failure harmed millions of American families, undermined the safety and soundness of the lending institutions themselves, and imperiled the economy as a whole. In Congress, a climate of deregulation and undue deference to industry blocked essential reforms. In the agencies, the regulators' failure to act, despite abundant evidence of the need, highlights the inadequacies of the current regulatory regime, in which none of the many financial regulators regard consumer protection as a priority.

As outlined in the testimony above, establishment of a single Consumer Financial Protection Agency is a critical part of financial reform. As detailed above, its funding must be robust, independent and stable. Its board and governance must be structured to ensure strong and effective consumer input, and a Consumer Advocate should be appointed to report semi-annually to Congress on agency effectiveness.

Our organizations, along with many other consumer, community, civil rights, labor and progressive financial institutions, believe that restoring consumer protection should be a cornerstone of financial reform. It will reduce risk and make the system more accountable to American families. We recognize, however, that other reforms are needed to restore confidence to the financial system. Our coalition ideas on these and other matters can be found at the Web site of Americans For Financial Reform, available at ourfinancialsecurity.org.

Thank you for the opportunity to testify. Our organizations look forward to working with you to move the strongest possible Consumer Financial Protection Agency through the Senate and into law.

Appendices:

Appendix 1: *Abusive Lending Practices by Smaller Banks and Thrifts*

Appendix 2: *Private Student Loan Regulatory Failures and Reform Recommendations*

Appendix 3: *Rent-A-Bank Payday Lending*

Appendix 4: *Information on Income (Primarily User and Transaction Fees Depending on Agency) of Major Financial Regulatory Agencies*

Appendix 5: *CFA Survey: Sixteen Largest Bank Overdraft Fees and Terms*

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[115] For further discussion, see Edmund Mierzwinski, "Preemption of State Consumer Laws: Federal Interference Is a Market Failure," *Government, Law, and Policy Journal of the New York State Bar Association,* Spring 2004 (Vol. 6, No. 1, pp. 6–12).

Appendix 1: Abusive Lending Practices by Smaller Banks and Thrifts

Members of Congress, the media and consumer organizations have properly focused on the role of large, national banks and thrifts in using unsustainable, unfair and deceptive mortgage and credit card lending practices. In contrast, smaller banks and thrifts have justifiably been praised for their more responsible lending practices in theses areas. However, when considering the need for and responsibilities of a federal Consumer Financial Protection Agency, it is also important to note that some smaller banks and thrifts have, unfortunately, been on the cutting edge of a number of other abusive lending practices that are harmful to consumers and that must be addressed by a CFPA.

High Cost Refund Anticipation Loans

The high cost refund anticipation loans (RALs) sold by tax preparers to the working poor are made by some of the largest banks, JPMorgan Chase and HSBC, but also by much smaller Santa Barbara Bank & Trust and Republic Bank & Trust. In fact, refund anticipation loans offered by the two smaller banks are much more expensive than those now sold by Chase and HSBC. For the 2009 tax season, a typical $3,000 refund anticipation loan cost $62.14 at H&R Block through HSBC and $62 through independent preparers who used JPMorgan Chase to make RALs. In contrast, Republic Bank & Trust charged $110.45 and Santa Barbara Bank & Trust charged $104.95 for the same $3,000 RAL. Furthermore, Santa Barbara permits the independent tax preparers with whom it partners to charge an additional $40 (we do not have information on the amount of additional fees for Republic Bank & Trust). With all fees included the annual percentage rate for RALs at the small banks ranged from 134 percent up to 187 percent for a $3,000 loan repaid by direct deposit of the taxpayers tax refund and/or Earned Income Tax Credits.[116]

Rent-A-Bank Payday Lending

Payday lenders partnered with small banks based in states with deregulated interest rates in order to make loans in states that retained usury laws, small loan rate caps, or had slightly restrictive payday loan laws. Through enforcement action, the Comptroller of the Currency stopped four small national banks from renting their charters to payday lenders. The Federal Reserve put regulatory pressure on the only state-chartered member bank involved in rent-a-charter lending and the bank withdrew from payday lending. The Office of Thrift Supervision prevailed on a small thrift in Ohio to stop.

For years, about a dozen very small state banks "rented" their charters to enable payday lenders to evade state usury and small loan protections. These banks ended this abusive practice only after state regulators and consumer attorneys initiated litigation, the National Association of Attorneys General sent a stern letter, consumer groups launched a multi-year advocacy campaign by across the country, key Congressional leaders sent letters, and new leaders at the FDIC used

[116] Chi Chi Wu and Jean Ann Fox, "Big Business, Big Bucks: Quickie Tax Loans Generate Profits for Banks and Tax Preparers While Putting Low-Income Workers at Risk," National Consumer Law Center and Consumer Federation of America, February 2009, page 10.

all the enforcement tools at their disposal.[117] By the time bank regulators deprived payday lenders of willing bank partners, state consumer protections had been undermined.

Bank Overdraft Loans

Small banks also extend extremely expensive unauthorized credit through overdraft loans, charging consumers steep fees for covering transactions on accounts with insufficient funds. Instead of denying point-of-purchase debit card purchases or cash withdrawals from ATMs, banks large and small cover those overdrafts and charge high fees. The FDIC issued a ground-breaking report in late 2008 based on a survey of 462 FDIC-supervised state banks drawn from a sample of 1,172 banks which included banks scheduled for examination from May through December 2007, as well as FDIC-supervised banks with at least $5 billion in assets. The FDIC found that 75.1 percent of the mostly small banks surveyed automatically enrolled customers in automated overdraft programs with some of them denying consumers the ability to even opt out of having overdrafts paid for a fee. The fees charged by FDIC banks ranged from $10 to $38 with the median fee $27. About a fourth of these state banks added sustained overdraft fees when consumers did not repay the overdraft in just days. A quarter of all banks surveyed and over half of the largest surveyed banks batch processed overdraft transactions largest to smallest, which the FDIC noted can increase the number of overdrafts. Small banks turn their overdraft programs over to third-party vendors to manage and pay them a percentage of the fees generated, typically 10 to 20 percent of additional fees.

Overdraft and insufficient funds fees are a major source of revenue for banks, including the smaller state banks supervised by the FDIC. These fees in 2006 represented three-quarters of the $2.66 billion in service charges on deposit accounts reported by the surveyed banks in their Call Reports. Banks that permit overdrafts at cash registers with debit cards and at ATMs collected more in fees than banks that deny those transactions at no cost to consumers. Banks that process withdrawals largest first also rake in more revenue than banks that do not.[118]

Third-Party Direct Deposit Arrangements with Check Cashers and Loan Companies

Last year, CFA surveyed third-party direct deposit account arrangements by which federal exempt funds are delivered to unbanked recipients through check cashers, loan companies, and other outlets that partner with a handful of banks. The *Wall Street Journal* published a front page story, titled "Social Insecurity: High Interest Lenders Tap Elderly, Disabled[119]," which described the high cost and unfair terms of financial arrangements that target low-income recipients of taxpayer-supported federal benefits. Readers were shocked to learn that the Social Security Administration would direct deposit Social Security and SSI benefits into a bank

[117] Jean Ann Fox, Consumer Federation of America and Edmund Mierzwinski, USPIRG, "Rent A Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections," November 2001. See, also, Jean Ann Fox, Consumer Federation of America, "Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury," March 2004, and Testimony, Jean Ann Fox, House Oversight and Domestic Reform Subcommittee on Domestic Policy Regarding Foreclosures, Predatory Lending and Payday Lending in America's Cities, March 21, 2007.

[118] FDIC, "FDIC Study of Bank Overdraft Programs," November 2008, pages ii-v.

[119] Ellen Schultz and Theo Francis, "Social Insecurity: High Interest Lenders Tap Elderly, Disabled," *Wall Street Journal*, February 12, 2008, A1.

account controlled by a loan company, not by the recipient. The Social Security Administration and Treasury Department permit delivery of exempt benefits through Master/Sub account arrangements that can include a bank, an intermediary, and the outlet where consumers go to pick up their "checks." Unbanked recipients are targeted by these "third-party direct deposit providers" as a means of getting faster access to their checks that is safer than receiving paper checks in the mailbox. Loan companies also use the direct deposit arrangements to secure repayment of loans before recipients gain access to their funds.

Banks set up a master account to receive exempt funds in the name of the recipient. The beneficiary goes to the check cashing outlet and pays to receive and then cash the "check" printed to deliver their funds or to have funds loaded onto a prepaid debit card. Fees are charged to set up the account, to deliver each payment, and to cash each check. The direct deposit accounts offered by check-cashers simply convert the electronic payment of benefits back into a paper check. When the benefits are delivered by debit card, recipients are provided a stored value card, which appears to be not covered by Federal Reserve Regulation E protections that provide limits on liability for unauthorized transfers, procedures to resolve disputes, disclosures, and other substantive protections.

Recipients who are enrolled in these third-party direct deposit accounts have no direct control over their funds. The bank deducts its fees and those paid to the check casher or other entity that delivers the "check" or provides the debit card. Contracts include fine print that permits the bank to channel exempt funds to make loan payments on behalf of the recipient before handing over the rest of that month's check. Recipients get what is left over.

CFA presented testimony to both the Social Security Administration and to the House Ways and Means Subcommittee on Social Security last June that detailed the bank/third-party arrangements in effect at that time. Banks included in the survey were Republic Bank & Trust, based in Louisville, Kentucky; River City Bank, based in Kentucky; Bank of Agriculture and Commerce in California; and First Citizens Bank/FirstNet/Cornerstone Community Bank based in Radcliff, Kentucky and Chattanooga, TN.[120] Following the hearing, the FDIC investigated and took regulatory action against the banks they supervise.[121]

Third-Party Subprime "Fee-Harvester" Credit Card and Loan Arrangements

Smaller banks also issue high fee, low limit credit cards to consumers with impaired credit. These "fee-harvester" cards are marketed to the most vulnerable consumers, and come with loaded high fees that use up most of the card's capacity, leaving consumers with minimal credit at an exorbitant price. While some large banks engaged in the fee-harvester sector, a report by the National Consumer Law Center identified several small banks that partnered with card issuers, including Columbus Bank and Trust and several other small banks that partnered with

[120] Testimony of Jean Ann Fox, Consumer Federation of America, Before the Subcommittee on Social Security, Committee on Ways and Means, "Hearing on Protecting Social Security Beneficiaries from Predatory Lending and Other Harmful Financial Institution Practices," June 24, 2008.
[121] "Bank Ordered to Cease and Desist 'unsound' Banking Practices," Central Valley Business Times, March 28, 2009. See also, Social Security Administration Policy Instruction: EM-09039, "FDIC Investigation of the Bank of Agriculture & Commerce One-Time-Only Instructions, effective date May 15, 2009.

CompuCredit Corporation in Atlanta, Georgia; South Dakota based First Premier bank; First National of Pierre (SD); First Bank of Delaware, and Applied Bank, formerly known as Cross Country Bank. A MasterCard issued by CorTrust exemplifies the abuses of fee-harvester cards, as it featured a $250 credit limit that was quickly consumed by a $119 Acceptance Fee, a $50 annual fee, and a $6 per month Participation Fee, leaving users just $75 in total usable credit. A First Bank of Delaware card issued by Continental Finance in 2007 started with a $300 credit limit but provided only $53 in usable credit after charging a $99 account set-up fee, an $89 Participation Fee, a $49 Annual Fee, and $10 per month in Account Maintenance fees.[122]

Last year the Federal Trade Commission and the FDIC brought charges against CompuCredit and its small bank partners, accused of using unfair practices in marketing fee-harvester cards. The small banks subject to the FDIC's enforcement actions included $118 million-asset First Bank of Delaware in Wilmington, Delaware and $794 million-asset First Bank & Trust in Brookings, South Dakota.[123] In addition, $6 billion-asset Columbus Bank and Trust, Columbus, Georgia, settled the FDIC's charges related to CompuCredit by agreeing to a Cease and Desist Order and paying $2.4 million in a civil money penalty.[124] First Bank of Delaware agreed to a cease and desist order which required the bank to terminate its relationship, not only to CompuCredit, but with seventeen third-party lending programs and providers in total. These third party entities included payday lender Check 'n Go Online, CashCall, Inc., ThinkCash (TC Loan Service LLC), Fortris Financial, LLC, and several prepaid card providers.[125] First Bank & Trust was ordered by the Office of Comptroller of the Currency in 2003 to stop partnering with payday lenders and to set aside $6 million to reimburse credit card customers impacted by deceptive lending practices.[126]

Bank Payday Loans

As described at length in a separate appendix on Rent-A-Bank payday lending, starting in the 1990s and early 2000s, many smaller banks partnered with payday lenders to pass on their preemptive powers to avoid state payday loan laws. Though those rent-a-bank partnerships have ended, preemptive bank payday lending has not.

MetaBank, a federally chartered savings association headquartered in South Dakota, offers the iAdvance line of credit on prepaid cards, including payroll cards. The loan operates exactly like a payday loan. The loans are small, short term credit with a flat fee ($25 per $200); require that the borrower have a regular paycheck (direct deposit of wages or government benefits onto the prepaid card); and lead to frequent rollovers and a triple digit APR. The disclosed APR is 150%, but that assumes that the loan is outstanding for 30 days. That is highly unlikely, as the loans are most likely taken out toward the end of the pay cycle. The APR is 650% if the loan is taken out a week before payday.

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[122] Rick Jurgens and Chi Chi Wu, National Consumer Law Center, "Fee-Harvesters: Low-Credit, High-Cost Cards Bleed Consumers," November 2007, Pages 1, 6.
[123] Cheyenne Hopkins, "Will Third-Party Crackdown Set Stage for Showdown?" American Banker, June 11, 2008.
[124] Press Release, "FDIC Seeks in Excess of $200 Million Against Credit Card Company and Two Banks for Deceptive Credit Card Marketing," June 10, 2008, http://www.fdic.gov/news/news/press/2008/pr08047.html.
[125] FDIC Stipulation and Consent to the Issuance of An Order to Cease and Desist, Order for Restitution, and Order to Pay, First Bank of Delaware, FDIC-07-256b. FDIC-07-257k, Exhibit A, October 3, 2008.
[126] Steve Young, "S.D. Bank Denies Credit Card Deception," Argus Leader, June 12, 2008.

But in several respects the loans are worse than payday loans. First, the bank is able to preempt state usury, small loan, and payday loan laws.

Second, unlike a payday lender, which must cash a check that can be stopped (at least in theory), the bank has immediate access to offset the loan against the next payment of the consumer's wages or benefits, even benefits that are exempt from garnishment.

Third, the cost can be much higher because the loan is not even necessarily outstanding the full two weeks that a typical payday loan is. It might only be a few days.

Some larger banks also have payday-loan products. Wells Fargo, Fifth Third Bank, and U.S. Bank have direct deposit account advances, which operate just like Meta Bank's iAdvance loans except that they offset a bank account not a prepaid card account.

Appendix 2: Private Student Loan Regulatory Failures and Reform Recommendations

During the height of the most recent wave of abusive mortgage loans, federal regulators took almost no public action. There was a similar lack of regulatory activity in the student loan area. There were problems in the federal student loan industry as well. However, at least for these products, there is a comprehensive set of borrower protections in the Higher Education Act (HEA) and a clear regulatory authority, the U.S. Department of Education. We recommend that jurisdiction over federal student assistance remain in the HEA and Department of Education.

In contrast, many different types of lenders originate, service, and collect private student loans and as a result, there is a wide range of regulatory agencies. These products are similar to other private unsecured credit products, such as credit cards.

In recent years, a subprime private student loan industry began to prey on vulnerable borrowers seeking to better their lives through education. Key problems included:

1. Pressuring Borrowers into High Cost Private Loans.
Many schools and lenders pressured borrowers into high cost private loans even in cases where borrowers had not yet exhausted the more affordable federal loans (and even grants in some cases). New York Attorney General Andrew Cuomo and others recently exposed many of the improper financial arrangements and collusions between schools and lenders.

2. Private Loans and Scam Schools.
As the private student loan industry developed, a particularly unholy alliance developed between unlicensed and unaccredited schools and mainstream banks and lenders. The creditors didn't just provide high-interest private loans to students to attend unscrupulous schools; they actually sought out the schools and partnered with them, helping to lure students into scam operations. Regulatory agencies for the most part ignored their responsibility to stop unfair lending practices.

A key regulatory check, the FTC Holder Rule, could be more efficiently enforced by a single agency with clear jurisdiction over all financial players. If banks are routinely being referred loans by schools and the schools are not arranging for the banks to put the notice in the notes as they are required to do, then the banks are using notes that violate federal law and should be liable for unfair practices.

Banking regulators must coordinate to enforce the FTC holder rule. The trade commission, state attorney generals, state licensing and accreditation agencies must review loan documents provided to students by schools and sue schools that violate federal law by not including the holder notice. Meanwhile, government agencies supervising lenders must monitor school notes and sue lenders that violate federal law by contradicting or otherwise trying to evade the holder requirement.

The FTC rule must also be amended so that lenders in addition to schools are obligated to include the notice. Other federal agencies must also adopt the FTC rule so that there is absolutely

no doubt that loan providers outside of the FTC's jurisdiction, including all national banks, can be held liable. A single agency should be able to more efficiently enact these reforms.

3. Unchecked Rates and Fees.
As in the subprime mortgage and credit card industries, very high cost loans were made to borrowers without evaluation of reasonable ability to repay. In a March 2008 report, NCLC surveyed a number of private student loan products and found that all of the loans in our survey had variable rates. The lowest initial rate in our sample was around 5% and the highest close to 19%. The average initial disclosed annual percentage rate (APR) for the loans in our survey was 11.5%.[127]

Some of the margins were shockingly high. Multiple loans in our survey had margins of close to 10%. None of the loans we examined contained a rate ceiling. A few set floors. These floors are particularly unfair for borrowers in an environment of declining interest rates.

There are no limits on origination and other fees for private student loans. According to the loan disclosure statements we reviewed, there were origination charges in all but about 15% of the loans. For those with origination fees, the range was from a low of 2.8% up to a high of 9.9%. The average in our survey was 4.5%. Most of the lenders in the private student notes we surveyed reserved the right to charge additional fees for other services.

4. Denying Access to Justice, including Mandatory Arbitration Clauses.
Sixty-one percent of the loan notes in the March 2008 NCLC report contained mandatory arbitration clauses. These clauses are just one example of lenders' systematic strategy to limit a borrower's ability to challenge problems with the loans or with the schools they attend.

5. Arbitrary and Unfair Default Triggers.
Borrowers are in default on federal loans if they fail to make payments for a relatively long period of time, usually nine months. They might also be in default if they fail to meet other terms of the promissory note. There are no similar standardized criteria for private loan defaults.

A few of the default "triggers" in the loans we reviewed in the March 2008 report were particularly troubling. For example, the typical loan we reviewed stated that borrowers could be declared in default if "in the lender's judgment, they experience a significant lessening of ability to repay the loan" or "are in default on any other loan they already have with this lender, or any loan they might have in the future."

Another troubling trigger is the lender's discretion to declare a default if the lender believes that the borrower is experiencing a significant lessening of her ability to repay the loan. If interpreted broadly, a borrower could be placed in default if she requests a temporary postponement of loan payments due to job loss or some other factor.

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[127] National Consumer Law Center, "Paying the Price: The High Cost of Private Student Loans and the Dangers for Student Borrowers" (March 2008), available at: http://www.studentloanborrowerassistance.org/uploads/File/Report_PrivateLoans.pdf.

6. Disclosures.
The Higher Education Opportunity Act (HEOA) amended TILA to significantly improve disclosures for private student loans. A coalition of consumer advocacy organization filed comments on these proposed regulations in May 2009.[128] There is significant overlap between the new private student loan disclosure requirements and disclosure requirements for other types of credit. Enforcement should be enhanced if jurisdiction is clearly within one oversight agency.

7. Lack of Loss Mitigation Relief.
A key barrier to improved assistance programs is that lenders have not been *required* to provide redress for their irresponsible actions. Voluntary efforts have been few and far between. Similar trends occurred in the mortgage industry where most creditors failed to act on their own to stem the foreclosure tide.

Meaningful assistance should include loan restructuring and flexible repayment. Servicers should have the authority to modify loan terms, change interest rates, forbear or forgive principal, extend maturity dates, offer forbearances, repayment plans for arrearages, flexible repayment and deferments. Congress and the Administration should also act to ensure that borrowers receiving relief through these programs do not face tax consequences.

8. False and Misleading Advertising.
Private student loans are increasingly sold directly to consumers. We recommend schools be required to certify these loans before funds are disbursed.

9. Data Collection.
It is very difficult to understand private loan trends, including such important data as default rates. There is no comprehensive data base for private loans as there is for federal loans. The new regulatory agency should develop a data base of easily accessible data. The lack of this type of information in the private student loan context is a major impediment to understanding the scope of the problem and helping borrowers.

10. Private Enforcement.
Victims of abusive lending practices have very little recourse because the industry often uses its market power to limit borrowers' access to justice. To be effective, consumer protection laws must: (1) give borrowers a private right of action, the right to pursue class actions, and the right to raise school-related claims and defenses against lenders in cases where the school and lender have a referral relationship or other close affiliation; (2) contain strong remedies and penalties for abusive acts; (3) provide effective assignee liability so that borrowers can pursue legitimate claims even when the originator has sold their loan; and (4) prohibit mandatory arbitration clauses that weaken victims' legal rights and deny them access to seeking justice in a court of law. Without these fundamental procedural protections, other consumer protection rules are unenforceable.

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[128] See http://www.studentloanborrowerassistance.org/uploads/File/policy_briefs/PrivateLoanCommentsJune09.pdf.

Appendix 3: Rent-A-Bank Payday Lending

Federal regulators also fueled the explosive growth of payday lending during the late 1990s and early 2000s by allowing banks to partner with loan companies to evade state protections. Payday lenders solicit consumers to write unfunded checks for immediate cash loans that are due in full on the borrower's next payday, in order to keep the check from bouncing. By claiming the right to "export" weak regulations from the states where their bank partners were based, payday lenders charged interest rates of 400 percent and higher in states with stronger laws.

The payday loan industry used its "National Bank Model" as a two-edged sword in state legislative debates, urging state legislators to legalize payday loans to "keep out" the out-of-state banks and provide "competition" for banks that brokered payday loans. Then, when industry-friendly laws were enacted, some payday lenders continued to partner with out-of-state banks to by-pass the limits in the new payday loan law. For example, ACE Cash Express was a leader in enacting the Colorado payday loan law but dropped its state license, claiming that its loans were made by a national bank. It is widely believed that payday loan authorizing legislation was enacted in Virginia because rent-a-bank payday lenders had entered the state and a state law was the only way legislators thought they could impact the market.

Payday lenders also used bank partners to stay in business when the North Carolina legislature permitted the payday loan law to sunset in 2001. Instead of closing up shop, payday lenders with about five hundred branches affiliated with national banks to continue making loans. By late 2001, the North Carolina Banking Commissioner reported that seven banks were partnering with payday lenders, including Peoples National Bank of Paris, Texas; First National Bank, Brookings, SD; First Bank of Delaware; Brickyard Bank, Illinois; County Bank of Rehoboth Beach, DE; Eagle National Bank, PA; and Goleta National Bank, CA. Eventually, the North Carolina Attorney General settled cases against the remaining "rent-a-bank" lenders to exit the state. Class action litigation against the same lenders continued.

To combat the explosion of triple-digit interest lenders in states with usury or small loan caps, state regulators and Attorneys General brought enforcement actions, filed litigation, and sought legislation to close loopholes being exploited. For example, the Massachusetts Banking regulators shut down a retail outlet that partnered with County Bank of Rehoboth Beach, DE for violating the Massachusetts usury and small loan act.[129] Other state regulators that went to court to stop rent-a-bank payday lending include Colorado, Georgia, North Carolina, New York, Oklahoma, and Ohio.

By partnering with banks located in states with no usury cap, payday lenders were able to charge consumers much higher rates than state laws permitted and use other loan features that trapped borrowers in debt. For example, a 2001 CFA/USPIRG survey found that ACE Cash Express (Goleta National Bank) and Advance America (BankWest, SD) charged Virginia consumers 442 percent APR for payday loans despite Virginia's 36 percent small loan rate cap. The same survey noted that Money Mart (Eagle National Bank) charged 455 percent APR and loan servicers for County Bank of Rehoboth Beach, DE charged 780 percent APR for two-week loans

[129] Press Release, Commonwealth of Massachusetts Consumer Affairs and Business Regulation, "High Rate Payday Loan Operation Shut Down by Consumer Affairs Agency," April 20, 2000.

in Virginia.[130] Rent-a-bank lenders also made loans that exceeded the limits set by states that had authorized this product. ACE Cash Express partnered with Goleta National Bank and Dollar Financial Group partnered with Eagle National Bank to make loans up to $500 in California, a state that limited payday loans to $255 (if a lender charged the maximum fee). Colorado's payday loan law prohibited loan renewals but rent-a-bank lenders "rolled over" loans three or four times, charging borrowers the fee each payday without paying off the loan. While it is difficult to quantify the cost of rent-a-bank payday lending to consumers, the Center for Responsible Lending wrote to the FDIC Board of Directors in 2004 that 3,000 payday loan stores were at that time partnering with FDIC-supervised state banks. CRL estimated that over one million borrowers annually were trapped in a cycle of borrowing at a cost of about $750 million in fees per year that would otherwise be illegal under state law.[131]

Timeline of regulatory actions

The campaign to stop banks from renting their charters to enable payday lenders to evade state usury, small loan, and payday loan laws stretched over a decade. Below are noted key regulatory developments that eventually stopped this tactic. This list does not include numerous class action lawsuits, advocacy campaigns, and state law enforcement cases that were also instrumental in curbing usury by banks through payday lending outlets.

1999: National and state consumer groups wrote to Comptroller of the Currency John D. Hawke, in mid-1999, to urge regulatory action on Eagle National Bank, a small bank based in Pennsylvania, which partnered with payday loan outlets to make loans in states that prohibited such high interest rates.[132] The Comptroller replied on November 30, 1999 that "In the final analysis, there may, practically speaking, be little that bank regulators can do to eliminate abusive payday lending practices that comply with existing law."

September 2000: Office of Thrift Supervision lowered Crusader Bank's CRA rating because of its payday loan operations. The bank was later acquired and the program was discontinued.

November 2000. The Office of Comptroller of the Currency and the Office of Thrift Supervision issued advisory letters warning banks of the risks of partnering with payday lenders. "Title loans and payday loans are examples of types of products being developed by non-bank vendors who have targeted national banks and federal thrifts as delivery vehicles…We urge national banks and federal thrifts to think carefully about the risks involved in such relationships, which can pose not only safety and soundness threats, but also compliance and reputation risks." The OCC and OTS letter bluntly noted "Payday lenders entering into such arrangements with national

[130] Jean Ann Fox and Edmund Mierzwinski, Consumer Federation of America and U. S. PIRG, "Rent-a-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections," November 2001, page 14.
[131] Mark Pearce and Eric Stein, Center for Responsible Lending, Letter to FDIC Board of Directors, Re: The Need for FDIC Action Regarding Payday Lending Rent-A-Bank Arrangements," August 26, 2004, page 15.
[132] California Reinvestment Committee, Consumer Federation of America, Consumers Union, Greenlining Institute, National Community Reinvestment Coalition, National Consumer Law Center, U.S. Public Interest Research Group, Woodstock Institute, Letter Re: Eagle National Bank and "Payday Loans," Address to The Honorable John D. Hawke, Jr., Comptroller of the Currency, July 27, 1999.

banks should not assume that the benefits of a bank charter, particularly with respect to the application of state and local law, would be available to them."[133]

April 2001: National Credit Union Administration issued a directive, reminding federal credit unions of their 18 percent annual interest rate cap and urging credit union members to serve the legitimate short term credit needs of their members.[134]

September 2001. The Comptroller of the Currency filed an amicus brief in the Colorado Attorney General's case against ACE Cash Express for failing to get a license to make payday loans after partnering with Goleta National Bank. In a dramatic break with OCC preemption policy, the Comptroller stated that "ACE is the only defendant in this case and ACE is not a national bank."[135]

January 2002: Comptroller of the Currency ordered Eagle National Bank to cease its payday loan program, noting that "the bank essentially rented out its national bank charter to a payday lender to facilitate that nonbank entity's evasion of the requirements of state law that would otherwise be applicable to it."[136]

September 2002: The Illinois banking regulator and the Federal Deposit Insurance Corporation set high enough capitalization requirements for Brickyard Bank that the bank withdrew from its payday lending arrangement with Check 'n Go in Texas and North Carolina.

October 2002: Comptroller of the Currency ordered Goleta National Bank to cease making payday loans. The bank had partnered with ACE Cash Express. This action also brought resolution to state litigation against Goleta in Ohio, Colorado, North Carolina and in class action lawsuits filed in Florida, Texas, Maryland, and Indiana.

January 2003: Comptroller of the Currency ordered Peoples National Bank to terminate its payday loan arrangements with Advance America due to safety and soundness concerns.[137]

January 2003: Comptroller of the Currency issued a cease and desist order to First National Bank in Brookings, SD to terminate its payday loan program.[138]

January 2003: The Office of Thrift Supervision directed First Place Bank in Warren, Ohio to terminate its payday loan arrangements in Texas with Check 'n Go.[139]

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[133] OCC Advisory Letter AL 2000-10, "Payday Lending," November 27, 2000, p. 1
[134] NCUA Letter to Credit Unions, Letter No. 01-FCU-03, April 2001.
[135] Amicus Curiae brief filed by Julie Williams, Chief Counsel, Comptroller of the Currency, State of Colorado v. ACE Cash Express, Inc., Civil Action No. 01-1576, United States District Court for the District of Colorado, September 26, 2001.
[136] Press Release, "OCC Orders Eagle to Cease Payday Lending Program," January 3, 2002, NR 2002-01.
[137] Office of Comptroller of the Currency, Notice of Charges for Issuance of an Order to Cease and Desist, In the Matter of Peoples National Bank, Paris, TX, AA-ED-02-03, May 17, 2002.
[138] Press Release, OCC, January 27, 2003.
[139] "Texas Payday Lending to End: First Place Lists Earnings," Tribune Chronicle, Warren, Ohio, Jan. 30, 2003.

July 2003: FDIC issued guidelines for bank payday loan programs that did not definitively prohibit rent-a-bank payday lending by banks.[140] State banks continued to partner with payday lenders.

October 2003: The FDIC permitted First Bank of Delaware to switch to its supervision after the Federal Reserve imposed stiff regulatory requirements on the bank's payday loan business.[141]

March 2005: The FDIC issued revised payday loan guidelines for banks which further tightened lending to repeat borrowers by limiting loans to no more than three months out of a twelve month period.[142]

February 2006: The FDIC reportedly sent letters to all the remaining rent-a-bank payday lenders, asking the banks to consider terminating their arrangements. Since this was not an enforcement action, the FDIC did not issue the letters publicly, but payday lenders and banks impacted filed notices with the SEC and issued press releases making it clear that the FDIC had lowered the final curtain on rent-a-bank payday lending. Rent-a-bank payday lending ceased by mid-2006.

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[140] FDIC, Guidelines for Payday Lending, issued July 2003.
[141] CFA Letter to FDIC Chairman Powell, October 8, 2003, www.consumerfed.org/fdicletter10-2003.pdf.
[142] Press Release, "FDIC Revises Payday Lending Guidance," March 2, 2005.

APPENDIX 4: Information on Income (primarily user and transaction fees depending on agency) of Major Financial Regulatory Agencies

OTS

User fee income 2008: $245.699 million (2009 estimated: $246.706)[3]
FY 2009 Budget: $246.706 million[3]
Consumer Affairs Budget: $4.4 million[4]
Consumer Affairs Budget percent of total budget: 1.78%
OTS receives no appropriations from Congress, budget funded by user fees.

OCC

User fee revenue: $ 707.5 million
Total Budget 2008: $749.1 million[2]
Consumer Affairs Budget: $12.1 million ($9.1 million in 2008)[2]
Consumer Affairs Budget percent of total budget: 1.21%
Total FY 2008 revenue: $736.1 million[2]
Revenue from investment income: $ 26.1 million
Other revenue: $2.5 million (Other sources of revenue include bank licensing fees, revenue received from the sale of publications, and other miscellaneous sources.)[2]
The OCC receives no appropriations from Congress.

FDIC

User fee revenue was $2.965 billion for fourth quarter 2008.[8]
FY 2009 Budget: $2,243,765,244 ($1,205,161,868 in 2008)[7]
FTE for Consumer Affairs: 28 (33 in 2008)[4]
Consumer Affairs Budget: $7.2 million ($4 million in 2008)[4]
Consumer Affairs Budget as % of total Budget in 2009: .32%

FTC

Funding:
FY 2008 HSR Filing Fees: $144.600 million [10]
Do-Not Call Fees: $19 million [10]
General Fund: $76.639 million [10]
FY 2008 Total Budget: $240.239 million[10]
FY 2008 Total FTE: 1,084 [10]
FY 2008 Consumer Protection Budget: $139.122 million [10]
FY 2008 Consumer Protection FTE: 581 [10]
% of total Budget spent on Consumer Affairs: 57.9%

FED

Total Revenue from services provided to depositary institutions: $773.4 million [1]
Income from Priced Services: $53.4 million [1]
Budgeted Cost of Consumer and Community Affairs: $38.2 million budgeted 2008-2009[11]
Total Board Operations: $706.3 million[11]
Percent of total Budget spent on Consumer Affairs: 5.04 %

SEC

FY 2009 Budget: $913 million[13]
SEC Source of Fees:
Registration of securities: Securities Act of 1933: $234 million (FY 2008 estimate)[13]
Securities transactions under the Securities Exchange Act of 1934: $892 million (FY 2008 estimate) [13]
Merger and Tender Fees under the Securities Exchange Act of 1934: $21 million (FY 2008 estimate) [13]
Collections amount total: $1,147 million (FY 2008 estimate) [13]
Investor Protection and Education Program: $124.449 million[13]
Investor Protection Budget is 14% of total Budget.[6]
Investor Protection, 524 FTE are 15% of all FTE.[6]
Congressional Appropriation FY 2008: $63 million[12]
Exchange Revenues:
Securities Transactions Fees $794.672 million[12]
Securities Registration, Tender Offer, and Merger Fees $161.377 million[12]
Total Exchange Revenues: $956.317 million. [12]

PCAOB

2008 accounting support fee of $134.5 million.[5]
Total Budget: $144.6 million for 2008.[5]
The PCAOB income is from registration fees, user fees and transaction fees as approved by the Commission.[5]

Sources:
[1] http://www.federalreserve.gov/boarddocs/rptcongress/annual08/pdf/fro.pdf
[2] http://www.occ.treas.gov/annrpt/1-2008AnnualReport.pdf
[3] http://files.ots.treas.gov/481151.pdf
[4] http://www.house.gov/apps/list/speech/financialsvcs_dem/viewsandestimates2009.pdf
[5] http://www.pcaobus.org/About_the_PCAOB/Budget_Presentations/2008.pdf
[6] http://www.sec.gov/about/secfy08congbudgjust.pdf
[7] http://www.fdic.gov/about/strategic/report/2007annualreport/bud_exp_prog.html
[8] http://www.fdic.gov/about/strategic/corporate/cfo_report_4qtr_08/sum_trends_results.html

[9] http://ftc.gov/os/testimony/P064814subprime.pdf
[10] http://www.ftc.gov/ftc/oed/fmo/budgetsummary08.pdf
[11] http://www.federalreserve.gov/boarddocs/rptcongress/budgetrev/br08alt.htm
[12] http://www.sec.gov/about/secpar/secpar2008.pdf#sec3
[13] http://www.sec.gov/about/secfy09congbudgjust.pdf

Appendix 5: CFA Survey: Sixteen Largest Bank Overdraft Fees and Terms

In mid-2009, CFA updated a survey of the largest banks using fee schedules, account agreements, and bank brochures from branches and websites at sixteen of the largest banks to learn more about current fees and overdraft terms and practices. This provides an update to a larger study conducted by CFA in 2005[143] and a 2008 survey for the Federal Reserve Reg AA docket comments.[144] In the 2005 study, CFA found that 80 percent of the 33 largest banks had contract terms that permitted non-contractual overdrafts. Current information from sixteen large banks indicates that all of them permit consumers to overdraw and all impose steep fees for those unauthorized loan transactions. None of the largest banks provide consumers the opportunity to affirmatively sign up for overdraft loans.

Big Bank Overdraft Fees

Big bank fees for a first overdraft in a one-year period range from $19 for the first overdraft at US Bank to $36 at SunTrust Bank and National City Bank. For some accounts, WAMU advertises that the first overdraft fee is waived. Some banks have tiered overdraft fees. The top maximum fee is $39 charged by Citizens Bank for three or more overdrafts in a year. The median top fee charged by the largest banks is $35 per transaction that overdraws an account, regardless of the amount of credit extended. Fourteen of the banks charge $35 or more per overdraft either initially or after a few overdrafts in a twelve month period.

Nine of the largest banks have tiered overdraft fee schedules, charging higher fees for more than one overdraft over a rolling thirteen month time period. In 2005, only three major banks used tiered fees. Regions Bank charges $26 for the first overdraft in a year, $35 for the second overdraft, and $37 each for three or more. US Bank charges $19 the first time, $35 for the second to fourth overdraft, and $37.50 thereafter. Fifth Third Bank switched to tiered fees in the last year, previously charging a flat $33 per overdraft. Fifth Third now charges $25 for the first overdraft, $33 for the second to fourth, and $37 for five or more. In February, Bank of America dropped its $25 initial overdraft fee and now charges $35 for each overdraft.

In addition to per incident overdraft fees, ten banks charge sustained fees when overdrafts are not repaid within a few days. The sustained overdraft fees range from a flat $25 at Chase after five days, $30 charged by BB&T after seven days (dropping to five days August 1), $35 at Bank of America after five business days, and $35 at Citizens and $36 at SunTrust after overdrafts remain unpaid for a week. If an overdraft remains unpaid ten days, Citizens Bank adds a second $35 sustained overdraft fee, for a total of $109 if the consumer had been overdrawn three times in the last year and failed to repay the overdraft and fees within ten days. Other banks charge a per day fee of $7 to $8 for overdrafts unpaid after a few days. This fee is going up as well. PNC recently raised its sustained overdraft fee from $6 to $7 for a maximum of $35 over five days.

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[143] Jean Ann Fox and Patrick Woodall, "Overdrawn: Consumers Face Hidden Overdraft Charges from Nation's Largest Banks," Consumer Federation of America, June 2005

[144] Consumer Federation of America, Comments, FRB Docket No. R-1314; OTS-2008-0004; NCUA RIN 3133-AD47, Reg AA, August 4, 2008.

Overdraft Fees Rise During Recession

CFA reported on overdraft fees and practices at ten large banks in comments filed with the Federal Reserve one year ago.[145] Half of those surveyed banks have increased overdraft fees in the last year, including addition in June of a $35 sustained overdraft fee at Bank of America, adoption of tiered rates by Fifth Third Bank with the maximum fee now $37 compared to a flat $33 fee in 2008, and a $4 hike in Citibank's overdraft fee. PNC increased its sustained overdraft fee by a dollar to $7 per day after four days overdrawn while SunTrust increased both its initial and sustained overdraft fees from $35 to $36.

Overdraft fees also went up at other banks since CFA filed comments with the Federal Reserve in March, 2009.[146] Regions Bank notified customers in Tennessee that its fees increased by a dollar or two for each tier, with the maximum fee now $37 after two overdrafts in one year. TD Bank added a $20 sustained overdraft fee after nine consecutive days of overdraft status.

Big Bank Fees and Daily Limits

Despite the Federal bank regulatory agencies' Best Practices[147] recommendation that banks limit the number of overdraft fees charged per day, only six of the sixteen large banks set maximum fees per day while the other ten banks charge an unlimited number of fees for a string of transactions that overdraw an account in one day. Citibank caps fees at four per day for a $136 total while WAMU limits its overdraft charges to seven per day ($238), up from five per day last year. TD Bank permits six overdrafts and six insufficient funds fees to be assessed in one day for a total of $420. US Bank limits total overdraft and NSF fees to 12 per day which would cost consumers up to $450 per day. Bank of America doubled its daily fee limit and now permits ten overdraft fees per day for a total of $350.

Bank Initial Overdraft and Sustained Overdraft Fees

Bank	OD Fee	Sustained OD Fee	Maximum Daily Fees
Bank of America	$35	$35 after 5 business days	Ten
BB&T	$35	$30 after 7 days	
Bank	**OD Fee**	**Sustained OD Fee**	**Maximum Daily Fees**
Chase	$25 first OD $32 2 to 4 OD $35 5 or more	$0 to $25 per OD after 5 days	No max

[145] Consumer Federation of America, Comments to Federal Reserve, Re: FRB Docket No. R-1314; OTS-2008-0004; NCUA RIN 3133-AD47, August 4, 2008.
[146] Consumer Federation of America, Comments to Federal Reserve, FRB Docket No. R-1343, March 30, 2009.
[147] Joint Guidance on Overdraft Protection Programs, 70 Fed. Reg. 9,127, 9,129-30 (Feb. 24, 2005)

Citibank	$34	No	4 fees per day
Citizens Bank	$25 first OD $37 2nd OD day $39 3 or more	$35 after 6 days $35 2nd fee after 10 days	
Fifth Third Bank	$25 first OD $33 2 to 4 OD $37 5 or more	$8/day after 3 days	No max
HSBC	$35	No	No max
National City Bank	$30 to $36	$8/day after 3 days	No max
PNC Bank	$31 1 to 3 OD $34 4 to 6 OD $36 7 or more	$7/day after 4 days Max $35 sustained	No max
Regions Bank	$26 first OD $35 2nd OD $37 3 or more	No	No max
SunTrust	$36	$36 on 7th day	No max
TD Bank	$35	$20 on 10th day	6 OD and 6 NSF
U.S. Bank	$19 first OD $35 2 to 4 $37.50 5 or more	$8/day after 3 days	6 OD and 6 NSF
Wachovia	$22 first OD $35	No	No max
WaMu	1 free OD $34	No	7 OD
Wells Fargo	$35	No	10 OD

Big Bank Overdraft Loans are Extremely Expensive

The combination of the initial overdraft fee and sustained overdraft fees charged within a few days of the incident make bank overdraft loans extremely expensive for consumers. Since sustained overdraft fees can be applied even before consumers are notified that their account is

overdrawn, it is difficult for consumers to avoid these extra fees. In addition, inadvertent borrowers are not likely to have funds to repay the overdraft and resulting fees until the next pay or benefit check is deposited into the account. Since banks collect payment by set off, the next deposit goes first to repay the overdraft loan and fee.

A $100 overdraft repaid after seven days would cost fees ranging from $34 at Citibank and WaMu to $74 at Citizens Bank, using the highest fees charged by these banks plus sustained overdraft fees that would apply after seven days. In June, Bank of America added a $35 sustained overdraft fee for overdrafts not repaid in five consecutive business days, doubling the cost of a single overdraft to $70 if not repaid immediately. The annual percentage rates, if these loans were repaid in seven days and were subject to TILA closed-end credit cost disclosure requirements, range from 1,768 percent to 3,848 percent APR. By comparison, payday loans for seven days usually cost 780 percent to 1,560 percent APR if the finance charge is $15 or $30 per $100 borrowed.

Total Cost of Bank Overdraft "Payday" Loans

This chart illustrates what a $100 overdraft would cost when the overdraft remains unpaid for seven days, using the bank's maximum fee and the sustained overdraft fees that would be imposed over a seven-day time period. The APR is computed as if this were a closed end one week payday loan.

Bank	Max OD Fee	Sustained OD Fee Times # of Days	Total	APR/7 days
Bank of America	$35	$35[148]	$70	3,640%
BB&T	$35	$30	$65	3,380%
Chase	$35	$12.50 (AZ)	$47.50	2,470%
Citibank	$34	0	$34	1,768%
Citizens	$39	$35	$74	3,848%
Fifth Third	$37	4x$8=$32	$69	3,588%
HSBC	$35	0	$35	1,820%

[148] Bank of America limited its initial overdraft fee for $10 for overdrafts of $5 or less.

Bank	Max OD Fee	Sustained OD Fee Times # of Days	Total	APR/7 days
National City	$36	4x$8=$32	$68	3,536%
PNC	$36	3x$7=$21	$57	2,964%
Regions	$37	0	$37	1.924%
SunTrust	$36	$36	$72	3,744%
TD Bank	$35	$20	$55	2,860%
U.S. Bank	$37.50	4x$8=$32	$69.50	3,614%
Wachovia	$35	0	$35	1,820%
WaMu	$34	0	$34	1,768%
Wells Fargo	$35	0	$35	1.820%

Transaction Clearing Practices

All of the largest banks maximize overdraft and insufficient funds fees by ordering the sequence of withdrawals to pay the largest transaction first or reserving the right to process withdrawals in any order the bank chooses. Since banks that cover overdrafts for a fee pay all or most transactions that overdraw an account, the only purpose to order payments largest first is to maximize fee revenue.

Traditional Overdraft Products for Nation's Sixteen Largest Banks

FIRM	Fee Schedule On Web	TRADITIONAL OVERDRAFT PROTECTION				
		Line of Credit transfer fee	Savings Transfer Fee	Credit Card	Home Equity	Opt-In Contract
Bank of America	Yes	$10; in increments of $100	$10; in increments of $100	see card agreement ; varies; linked to Bank of America credit card only		Yes

FIRM	Fee Schedule On Web	TRADITIONAL OVERDRAFT PROTECTION				
		Line of Credit transfer fee	Savings Transfer Fee	Credit Card	Home Equity	Opt-In Contract
BB&T	No	$10 ; in increments of $100	$10; increment of $100	$10 ; increments of $100	Yes	Yes
Chase	No	$10 per transfer	$10	13.99% APR	Yes	Yes
Citibank	Yes	Yes; Checking Plus, 16.5% variable APR in most states, $5 annual membership fee	$10			Yes
Citizens Bank	No	$15 per day plus $25 line of credit annual fee	$15 per day			
Fifth Third Bank	Yes	Yes	$10 for 1-10 uses; $15 for 11-20 uses; $20 for 21+ uses	$10-1-10 times; $15 11-20 times; $20 21 or more + APR	Info not found	Yes
HSBC	No	$15	$15	$15		Yes
National City Bank	Yes	$3 mo. Service fee; 24.8% APR	$15			Yes
PNC Bank	Yes	Yes	Yes, $10 transfer fee, exact amount of OD and fee transferred	Yes, $10 transfer fee, $50 minimum transfer		Yes; w/ set up fee of $15 for Free Checking, $5 for Foundation Checking, and free for all other checking accounts

FIRM	Fee Schedule On Web	TRADITIONAL OVERDRAFT PROTECTION				
		Line of Credit transfer fee	Savings Transfer Fee	Credit Card	Home Equity	Opt-In Contract
Regions	No	Yes, $10 transfer fee per day, $7.50 per day for Preferred Plus Banking	Yes, $10 transfer fee per day, $7.50 per day for Preferred Plus Banking	Yes, $10 fee per day, $7.50 for Preferred Plus Banking		Yes, subject to credit approval. Transfers in $100 increments.
SunTrust	Yes	Yes	$10 transfer fee (max one per day) $100 transfer increments	Yes		Yes
TD Bank	No	$5 per daily transfer from Moneyline	$5 per daily transfer			Yes
US Bank	Yes	Yes, three different lines of credit are offered	$5 fee on deposit account per item covered for all overdrafts, auto increments of $200 or avail balance	Yes, $10 fee, payments are 3% of balance or $10, auto increments of $25 up to credit limit	Yes	Yes
Wachovia	No	Yes, $10 transfer fee charged to card	Yes, $10 transfer fee	Yes, $10 transfer fee + APR		Yes
Washington Mutual	No		$12 if balance under $10,000			"Overdraft Limits" program is automatic, other programs are opt-in
Wells Fargo	some info online	$10	$10 per transfer, $25 minimum or exact OD amount	$10-$20 depending on $ amount of advance; one fee per day		Yes

Fee-Based Overdraft "Protection" for Nation's Sixteen Largest Banks

FIRM	Clearance Policy	"COURTESY" OVERDRAFT LOANS			
		Unpaid NSF/ Overdraft Fee	Paid Overdraft Fee	Sustained Overdraft Fee	After Number of Days
Bank of America	Any; usually high to low	$35 per item; limit 10 per day	$35 per item; limit 10 per day; $10 fee per OD if total overdrafts per day less than $5	$35	5 consecutive business days
BB&T	High to low	$35 per item; no limit per day.	$35 per item; no limit per day	$30	7 days (5 days 8/1/09)
Chase	High to low, can change order w/out notice	$25-1st time, $32-2nd,3rd,4th time, $35 thereafter	$25-1st time, $32-2nd,3rd,4th time, $35 thereafter	No fee to $25 per incident depending on your location	5 consecutive business days
Citibank	Electronic debits first then usually high to low	$34; not more than 4 fees per day; fees may also cause an overdraft	$34; not more than 4 fees per day; fees may also cause an overdraft	No	
Citizens Bank		$25 per item 1st day; $37 2 OD days, $39 3 or more OD days	$25 per item 1st day; $37 2 OD days, $39 3 or more OD days	$35	6 consecutive business days; another fee if account still overdrawn 10 business days
Fifth Third Bank	High to low.	$25 for 1st time; $33 for 2nd-4th time; $37 thereafter per item	$25 for 1st time; $33 for 2nd-4th time; $37 thereafter per item	$8 per day	3 days
HSBC	High to low	$35 per item; no limit per day	$35 per item; no limit per day	No	
National City Bank	High to low (2005)	$30-36; based on NSF activity and balances	$30-36; based on NSF activity and balances	$8.00	3 consecutive days

PNC Bank	High to low (2008)	1-3 items = $31/item 4-6 items = $34/item 7+ = $36/item	1-3 items = $31/item 4-6 items = $34/item 7+ = $36/item	$7 per day	4 consecutive calendar days, $35 max total
Regions	Any order, reserve right to pay largest first, to change order without notice	1 item = $26 2nd item = $35 3+ items = $37	1 item = $26 2nd item = $35 3+ items = $37	No	
SunTrust	Any; usually high to low	$36	$36	$36	6 consecutive calendar days, fee imposed on 7th consecutive day
TD Bank	Any order	$35 per item; limit 6 per day	$35 per item; limit 6 per day	$20	9 consecutive business days of overdraft status
US Bank	Any; bank has total discretion	$19 1st time, $35 2nd-4th time, $37.50 5th time and thereafter; max 6 per day	$19 1st time, $35 2nd-4th time, $37.50 5th time and thereafter; max 6 per day	$8 per day	3 days
Wachovia	Any; usually high to low	$22 1st time and $35 each additional time	$22 1st time and $35 each additional time	No	
Washington Mutual	Any. Preference given to WAMU payments	$34 each, max 7 per day	$34 each, max 7 per day	No	
Wells Fargo	High to low	$35 –max 10 per day	$35 – max 10 per day		

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The Consumer Financial Protection Agency (CFPA), as proposed by the Obama Administration, is intended to be an independent agency with sole rule-making and enforcement authority for all Federal consumer financial protection laws (with the exception of those covered by the SEC and the CFTC). The draft legislation [1] submitted by the Administration gives the agency jurisdiction over all companies, regardless of size, that are engaged generally in providing credit, savings, collection, or payment services. This is accomplished by transferring to the CFPA most or all of the authorities in 16 Federal statutes—ranging from the CRA to the Truth in Savings Act—that cover lending, mortgage financing, fair housing, credit repair, debt collection practices, fair credit reporting, and a multitude of other consumer financial products and services. The agency will be funded by fees imposed on the thousands of companies—from banks and credit card companies to local finance companies and department stores—that are subject to the legislation. In many cases, the agency's jurisdiction will be concurrent with the jurisdiction of State agencies, but the CFPA will not preempt State law.

Prior to submitting the legislation, the Administration circulated a white paper [2] that contains clear Statements of the policies and intentions underlying the legislation. In this testimony, I will refer to the white paper as well as the legislation itself.

As might be expected, the new agency will have jurisdiction over disclosure to consumers. This is the customary way that consumer protection has proceeded at the Federal level. In the past, consumers were generally expected to have the ability to make decisions for themselves if they were given the necessary information. The securities laws, for example, are largely consumer protection laws, developed during the New Deal period. In selling a security, an issuing company and any underwriter or dealer must supply investors with all material facts, including any additional facts needed to ensure that the information disclosed is not misleading. This approach has worked well for 75 years.

The material facts standard of the SEC is of course subject to interpretation, but it is possible to give it some content by imagining what an investor would want to know about the risks a company faces and its financial and business prospects. The white paper States that the CFPA will use a "reasonableness" standard, which it defines as "balance in the presentation of risks and benefits, as well as clarity and conspicuousness in the description of significant product costs and risks." The draft legislation follows this pattern, so that disclosure to consumers must—perhaps like a drug label or a securities prospectus—include both the benefits and the risks of a product or service. These will be difficult guidelines for the regulated industry to follow, especially because enforcement actions and lawsuits may result from violations. Despite substantial disclosure on drug labels and in securities prospectuses—in some cases ordered by the regulatory agency—successful law-suits in both areas have claimed that the disclosure was not sufficient.

The Suitability Problem

The real trouble begins, however, when the Administration's plan gets beyond the relatively simple issue of disclosure and proposes that the CFPA define standards for what the white paper calls "plain-vanilla" products and services. The draft legislation describes them as "standard consumer financial products or services" that will be both "transparent" and "lower risk." According to the white paper, the CFPA will have authority "to require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer." [3] This idea, seemingly quite simple, raises a host of significant questions. If there is a plain-vanilla product, who is going to be eligible for the product that has strawberry sauce? In other words, once the baseline is established for a product that can or must be offered to everyone, who is going to be eligible for the product that, because of its additional but more complex features, offers financial advantages? This is the

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[1] Consumer Financial Protection Agency Act of 2009, §1018, as proposed by the U.S. Department of the Treasury, June 30, 2009, available at *www.financialstability.gov/docs/CFPA-Act.pdf* (accessed July 6, 2009).

[2] U.S. Department of the Treasury, "Financial Regulatory Reform: A New Foundation" (June 30, 2009), 55–56, available at *www.financialstability.gov/docs/regs/FinalReport_web.pdf* (accessed July 6, 2009).

[3] *Ibid.,* 15.

suitability problem—requiring providers to decide whether a particular product or service is suitable for a particular customer—and the Administration's plan is caught in its web.

As an example, consider a mortgage with a prepayment penalty. The white paper notes that the "CFPA could determine that prepayment penalties should be banned for certain types of products, because penalties make loans too complex for the least sophisticated consumers or those least able to shop effectively."[4] This seems logical if one assumes—as the Administration seems prepared to do—that some consumers can be denied access to products they want. As the white paper notes, "[t]he CFPA should be authorized to use a variety of measures to help ensure alternative mortgages were obtained only by consumers who understood the risks and could manage them."[5]

So, what about the husband and wife who intend to keep their home until their children are grown and are willing, for this reason, to accept a prepayment penalty in order to get a lower rate on their fixed-rate mortgage? The Administration is suggesting that this option might not be available to them if the mortgage provider (and ultimately the CFPA) does not consider them "sophisticated" consumers. This kind of discrimination between and among Americans is something new and troubling. The Administration's plan clearly intends for some consumers to be denied access to certain products and services. "As mortgages and credit cards illustrate," the white paper declares, "even seemingly 'simple' financial products remain complicated to large numbers of Americans. As a result, in addition to meaningful disclosure, there must also be standards of appropriate business conduct and regulations that help ensure providers do not have undue incentives to undermine those standards."[6] In other words, by requiring that all providers offer plain-vanilla products and services in addition to other products, the Administration is creating a regime in which providers must keep "complicated" products out of the hands of Americans who may not be able to understand them.

This approach bears a strong resemblance to a paper published in October 2008 by the New America Foundation.[7] One of the authors of the piece, Michael Barr, is now an assistant secretary of the Treasury. The underlying theory of the Barr paper is that consumers should be offered a baseline, simple and low risk version of every product offered by credit and other financial providers. This simple product is called a "plain-vanilla" product in the New America Foundation paper, just as it is in the Administration's white paper. Referring to mortgages, the Barr paper describes this sequence of events: "Borrowers . . . would get the standard mortgage offered, unless they chose to opt out in favor of a nonstandard [*i.e.,* more complex and risky] option offered by the lender, after honest and comprehensible disclosures from brokers and lenders about the terms and risks of the alternative mortgages. An opt-out mortgage system would mean borrowers would be more likely to get straightforward loans they could understand."[8]

What the Barr paper fails to understand is the risks that are faced by the provider in offering to customers anything more complex than the plain-vanilla product. Although providers will be free to do so, the possibility of enforcement actions by the CFPA or the Federal Trade Commission, suits by State attorneys general (specifically authorized to enforce the CFPA's regulations), and the inevitable class action lawsuits will make the offering of the more complex product very risky. Although the Barr paper suggests that the provider can protect itself by making a full and fair disclosure, even the white paper recognizes that this is unlikely to be effective. The white paper notes: "Even if disclosures are fully tested and all communications are properly balanced, product complexity itself can lead consumers to make costly errors."[9] When these costly errors are made, they will be *prima facie* evidence that the product was too complex for the consumer, and the provider will be faced with a fine, an expensive enforcement action, or worse. Thus, we are not talking about a question of disclosure—making the risks and costs plain. Instead, what the Administration is setting up is a mechanism that will ultimately deny some people access to some products because of their deficiencies in experience, sophistication, and perhaps even intelligence.

This approach seems to be an unprecedented departure by the U.S. Government from some of the fundamental ideas of individual equality that have underpinned

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[4] *Ibid.,* 68.
[5] *Ibid.,* 66.
[6] *Ibid.,* 67.
[7] Michael Barr, *et al.,* "Behaviorally Informed Financial Services Regulation", New America Foundation, October 2008.
[8] *Ibid.,* 9.
[9] White paper, 66.

U.S. society since its inception. Conservatives have long argued that liberalism reflects a paternalistic desire on the part of elites to control and limit others' choices while leaving themselves unaffected. The white paper seems to validate exactly that critique. Providers will be at risk if they offer some products to ordinary consumers but could feel safe in offering the same products to those who are well educated and sophisticated. In important ways, the Administration's approach raises the issues in the famous Louis Brandeis Statement, quoted by Milton and Rose Friedman at the beginning of their book, Free to Choose: "Experience should teach us to be most on our guard to protect liberty when the Government's purposes are beneficial. Men born to freedom are naturally alert to repel invasion of their liberty by evil-minded rulers. The greater dangers to liberty lurk in insidious encroachment by men of zeal, well-meaning but without understanding." [10]

In addition, there are troubling questions about how determinations of sophistication or even mental capacity are going to be made, who is going to make them, and what standards will be followed. It appears that the provider must make this decision, but what kinds of guidelines will the CFPA provide to protect the provider against the inevitable legal attacks? Vague language in the legislation suggests the consumer can opt out of the plain-vanilla alternative, but as noted above this simply changes the nature of the provider's risk from the qualities of the product to the qualities of the disclosures that were made to the consumer about what such an opt out would mean. Finally, the elements of a plain-vanilla mortgage can be quite arbitrary, forcing people into structures that are financially disadvantageous. How can anyone know, for example, whether a 30-year fixed-rate mortgage is better than a 30-year adjustable-rate loan with a reasonable cap on interest costs? If interest rates rise in the future, the fixed-rate mortgage is best, but if they fall, a variable rate should be preferred. Should a Government agency have the power to determine whether a homebuyer is allowed to make this choice?

In contrast, the disclosure system has always seemed appropriate in our society because it does not require invidious or arbitrary discrimination between one person and another. As long as the disclosure is fair and honest, why should anyone be prohibited from buying a product or service? While it is apparent that everyone is not equal in understanding or sophistication, our national sensibility has been that these differences should be ignored in favor of the higher ideal of equality. Where consumers of limited understanding are protected by this system is through consumer protection actions that charge providers with fraud and deception while taking into account the limited capacities of the consumer. Under this approach, fraud and deception are punished, but the Government is not involved *ex ante* in deciding whether one person or another is eligible to receive what our economy has to offer. Yet the white paper says: "The CFPA should be authorized to use a variety of measures to help ensure that alternative mortgages were obtained only by consumers who understood the risks and could manage them. For example, the CFPA could . . . require providers to have applicants fill out financial experience questionnaires." [11] If this sounds a bit like a literacy or property test for voting—ideas long ago discredited—it is not surprising. Both impulses spring from the same source: a sense that some people are not as capable as others to make important choices.

To be sure, the securities laws contemplate that some distinctions will be made among customers on the basis of suitability. A broker-dealer may not sell a securities product to a customer if the customer does not have the resources to bear the risk or the ability to understand its nature. This is the closest analogy to what the Administration is contemplating for all consumers, but as a precedent it is inapposite. Owning a security is not a necessity for living in our economically developed society, but obtaining credit certainly is. Whether through a credit card, an account at a food or department store, a car loan, or a lay-away savings plan at a local furniture dealer, credit is a benefit that enables every person and every family to live better in our economy. Denying a credit product suitable to one's needs but deemed to be beyond one's capacity to understand has a far greater immediate adverse effect on a family's standard of living than telling an investor that a collateralized debt obligation is not a suitable product for his 401(k).

Moreover, investors tend to be customers of broker-dealers over extended periods, so their financial and other capacities are well known to the brokers who handle their accounts. This is unlikely to be true for various credit products, which are likely to be established in single transactions and with little follow-up. Any attempt to determine a customer's ability to handle the risks associated with, say, a credit card could also involve investigation into matters that the customer considers private. Neither the draft legislation nor the white paper suggests how the provider of a fi-

[10] *Olmstead v. United States,* 277 U.S. 479 (1928).
[11] White paper, 66.

nancial service is to determine suitability while still protecting the customer's privacy. As discussed below, simply determining what other credit products and obligations particular applicants might have—and thus whether they are able to meet their obligations—will be difficult and costly. These problems do not normally arise in the suitability inquiry that broker-dealers must undertake.

Other Effects

Several other serious problems arise out of the structure that the Administration seems to have in mind. The decision on a particular consumer's eligibility for a product will not be made by the CFPA but by the provider of the product or service. Apart from consumers themselves, providers are the first victims of this legislation. They will have to decide—at the risk of a CFPA enforcement action or a likely lawsuit—whether a particular customer is suitable for a particular product. This will place them in a difficult, if not impossible, position. If they accede to a customer's demand, and the customer later complains, the provider may face a costly enforcement proceeding or worse, but if the provider denies the customer the desired product, the provider will be blamed, not the Government agency. In not a few cases, the provider may be sued for denial of credit to someone later deemed suitable, rather than for granting credit to a person later deemed unsuitable. The white paper points out that the Administration does not intend to disturb private rights of action and in some cases "may seek legislation to increase statutory damages." As noted above, State attorneys general are specifically authorized to enforce the CFPA's regulations. Although the white paper offers the possibility that a provider might get a "no action letter" or approval of its product and its disclosure, the personal financial condition and other capacities of the customer are what will count, not the simplicity of the product.

The second victim will be innovation. Why should anyone take the risk to create a new product? Even if the CFPA will review it to determine whether it is accurately and fairly described—a process that may require the services of a lawyer and the usual expenses of completing applications and answering questions from a Government agency—the developer will still have to decide whether the people who want it are suitable to have it. The suitability decision can be expensive; a provider's better choice might be to stay with plain-vanilla products and give up the idea of developing new products to attract new customers.

The third victim will be low-cost credit. The tasks of getting approval for a product and investigating the suitability of every person who wants something more than a plain-vanilla product—whatever that may be—will substantially increase the cost of credit and reduce its availability. Leaving aside the effect on economic growth generally, higher credit costs and the denial of credit facilities that are deemed to be unsuitable for particular consumers will seriously impair the quality of life for many people of modest means or limited education. Credit provided by stores to regular customers may become too costly to administer. As a result, small neighborhood establishments may simply abandon the idea of providing credit and small finance companies and other small enterprises engaged in consumer financial services may well go out of business or merge with larger competitors. Even large credit providers may find that the additional business they attract with this service does not compensate for the risk and expense. Withdrawal of these competitors from the market will not only mean that many customers will be deprived of any credit sources and other services, but also that the reduced competition will allow credit fees to rise.

Litigation will also be a factor in the decision of credit sources about whether to develop new products or offer the complex products and services that might lead to disputes with customers or the CFPA. Investor complaints about suitability in the securities field are handled through an arbitration process, so that an investor who claims that he was sold a product for which he was unsuitable must make his case to an arbitrator rather than a court. The current costs of a mistake in the suitability judgment are thus much smaller for the broker-dealer. The legislation would give the CFPA the authority to ban mandatory arbitration clauses in credit arrangements, and the white paper recommends that the SEC consider ending the arbitration process for securities. If the SEC decides to do this, litigation in the securities field will substantially increase the costs of broker-dealers and investment advisers.

Finally, inherent conflicts between consumer protection and prudential regulation will arise when consumer protection responsibility is moved from the bank supervisors to the CFPA. How these might be resolved has not been described in the legislation and, perhaps was not considered. For example, as noted above, the white paper suggests that prepayment penalties should be banned for certain types of products because they make loans too complex for the least sophisticated consumers. A prudential supervisor, however, might want prepayment penalties to be included

in a prudently underwritten mortgage, since the ability of the borrower to prepay at any time without penalty raises the lender's interest rate risk. It is likely that the bank supervisors and the CFPA will have different policies on this and many other issues, and the banks will be caught in the middle.

Conclusion

The Consumer Financial Protection Agency Act of 2009 is one of the most far-reaching and intrusive Federal laws ever proposed by an Administration. Not only does it reach down to regulate the most local levels of commercial activity, but the act would also set up procedures and incentives that will inevitably deny some consumers an opportunity to obtain products and services that are readily available to others. This legislation should be rejected.

PREPARED STATEMENT OF SENDHIL MULLAINATHAN

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JULY 14, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for providing me with an opportunity to testify. By way of background, I am a Professor of Economics at Harvard who specializes in behavioral economics, a topic that combines two areas—economics and psychology. Any discussion of financial regulation must incorporate both areas—economists have a healthy respect for market forces while psychologists have a healthy respect for both people's immense capacities and limitations; they recognize that people are not financial engines churning out optimal choices in all environments. Understanding the current crisis—with its combination of competing lenders and sometimes-confused borrowers—requires behavioral economics.

In my comments I will make four points:

- First, some decision environments allow consumers to choose well while others result in poor choices.
- Second, when customers choose well there is healthy competition: firms clamor to provide better products at lower prices. When customers choose badly, there can be a race to the bottom. Even a few unprincipled firms offering products that exploit human fallibility can put pressure on the entire market.
- Third, a two-part approach to financial regulation can promote consumers capacity to choose well. Safe products would be lightly regulated while less safe ones—where low road firms could potentially exploit customers—would be more heavily regulated. A fence around the safer products creates a more level playing field between safe and less safe but superficially attractive products. It provides an additional tool that is less intrusive than bans, mandates or selective bans for some customers. It allows all customers to access products but simply ensures that those who access less safe ones would be doing so with greater safeguards.

Though the scope of the proposed regulation is broad, I will use the choice between mortgages—at the heart of the current financial crisis—to illustrate my points.

Choosing Well and Badly

First, let me describe the psychology of choice. Over the decades much research has helped us understand how people choose. I will illustrate the insights from this research using two familiar examples.

Most of you have painted a room in your house. You probably remember choosing from thousands of colors; Benjamin Moore alone proudly offers 140 shades of white. How do you tackle this ocean of choice? You pick a general color—blue, yellow, whatever. You pick a few shades within that color. You try them out in small swatches on one wall, see if you like them and repeat until you have a color you like. The bottom line: despite the explosion of choice people are largely happy with the end outcome. And certainly we don't think the Government could step in and improve this market through regulation.

I am also sure most of you have bought a digital camera. Going into the electronics store, you have some sense of what you want—do you need a small camera or a big one, do you prefer one brand over another? But once there the problem gets tougher. One camera has 8 megapixels and is smaller and cheaper; another has 12 megapixels and is bigger and more expensive. How do you choose? What is a

megapixel? How many is enough? Are 8 megapixels 50 percent better than 12? You can ask the camera salesman but are his incentives to give you the best advice? If the bigger camera is the cheaper per megapixel it may draw you to buy that one even without knowing fully understanding what megapixels are. Though there are far fewer cameras than paint colors the choice is far more difficult. At the end of the process, you hope you have bought the best camera but you're never really sure.

Part of choosing a mortgage is like choosing a paint color. Choosing a 30-year fixed rate mortgage means deciding on what is an affordable monthly payment. How much do you earn? What are your other expenses? The consumer can intuit much of this—in fact they may know it better than any outsider.

But sometimes when choosing a mortgage you encounter features all too similar to megapixels. Suppose one mortgage costs $1,000 a month for the first 2 years and then the payment is 3 points above 1 month LIBOR, while another says it is $900 a month and then the payment is 4 points about the 1 year constant Treasury bills rate. How do you make this choice? What is the difference between the LIBOR and the T-Bill rate? How much do they vary? Are 3 and 4 points about the right number? If the provider says you can refinance in 2 years, should you worry about being able to get another loan? Notice that in this morass, the $900 mortgage has some appeal; whatever else, it is cheaper now and allows you afford a bigger house. Few know the answers to these questions and those who do are the kind of people you avoid at a dinner party. This is worse than megapixels.

Choices such as these are at the heart of why choosing mortgages and other financial products pose so many difficulties for customers. With paint, you can try different colors; you can't really try on many mortgages. With paint, you get feedback; with mortgages feedback comes rarely and far too late—when the payments explode. With paint, a mistake is, well, easily painted over; with mortgages mistakes have lifetime consequences. And most importantly, we understand the colors we like whereas few of us understand the financial technicalities that can have large consequences.

Under such conditions, errors abound. For example, as Bucks and Pence show in their recent study "40 percent of borrowers with income less than $50,000—corresponding roughly to the bottom half of the income distribution of ARM borrowers—do not know the per-period caps on their interest rate changes."[1] To cite another example, nearly 50 percent of ARM borrowers think their mortgages can be converted to fixed rate ones whereas only 9 percent actually appear to be convertible.

Put simply, confusing choices do not represent real choices. Rather than empowering consumers it can frustrate them. To promote effective free choice one must ensure the choices can be made sense of.

Competition

This leads to my second point: how markets operate depends on how people choose. It is useful to separate the world between high road and low road lenders. High road lenders are in the game for the long run and trying to do what is best for their customers. They recognize that a bad mortgage is bad for business in the long run. Low road lenders have shorter time horizons; their management is focusing on the bottom line now. These firms would give out a bad mortgage—one that hurts consumers—if it makes them money today, even if it costs them in the long term.

The fortunes of high and low road firms depend on how people choose. When people choose well, low road firms can do no better than offer better products or lower prices. Here markets work well and innovation helps consumers.

Things change when consumers are choosing badly. High road firms now suffer from the actions of low road ones. Suppose a consumer is offered a reasonable 30-year fixed rate mortgage by one firm and offered a balloon ARM with an appealing teaser rate. Unless they understand the arcane financial details of the adjustable rate jump and amortization clauses, the balloon ARM will look deceptively attractive. The better product can look like the worse product. One lender offers a reasonable debt-to-income; another a much less safe debt-to-income. One lender offers standard principal payments while another offers a payment option ARM and advertises the minimum payments that do not even cover interest and lead to negative amortization. In all these cases, customers could easily be misled as to which is the good safe product and which is the bad unsafe one. Good firms suffer again when

[1] Brian Bucks and Karen Pence (2006) "Do Homeowners Know Their House Values and Mortgage Terms?" Federal Reserve Board of Governors. FEDS Working Paper No. 2006-03. Available at SSRN: *http://ssrn.com/abstract=899152.*

they start losing staff to bad firms who can pay more. And so on. This can lead all firms to begrudgingly adopt low road strategies.

John Bogle, founder of Vanguard, has personal insight into this process. Vanguard faced it directly in marketing a no-load minimum-fee index fund. He points out that competition from (what I refer to as) low-road funds has shifted the "industry's focus from management to marketing." He further notes, "Small wonder that in all the rush to salesmanship in the fund industry, stewardship seems to have been left in the dust."[2]

The experience of credit unions provides another interesting window in to the race to the bottom. Because of their structure—they are not for profit cooperatives—they may be better equipped to resist low road approaches. According to a recent Experian-Oliver Wyman study, credit unions are experiencing as little as one-fifth the delinquency rate on mortgages and half the delinquency rate on credit cards as banks, even within the same credit score band.[3] This does not mean credit unions are necessarily a panacea to the mortgage problem; it merely illustrates the possibility of a high-road strategy.

When consumers choose badly innovation—one of the greatest benefits of markets—is also perverted. What did mortgage markets innovate in the beginning of this decade? Teaser rates, negatively amortizing loans, exploding subprime interest rates, prepayment penalties and low- or no-doc lending are hardly shining examples of how financial innovation helps consumers. Instead these products, while surely useful for a few customers, have been abused because they have a superficial appeal to confused customers. They likely contributed heavily to the defaults we must now deal with. In short, when borrowers choose badly innovation can be geared towards exploiting mistakes rather than producing products that help customers.

The Challenge of Regulation

I believe the financial crisis we have faced illustrates the importance of how market forces combine with how people choose. When the worst of these collide—bad banks introducing mortgages that exploit confused customers—the result is a toxic combination that leaves not just consumers but the entire financial system at risk. Successful financial regulation must pay attention to both of these.

The challenge of regulation is to ensure a system where customers can choose well according to their needs. In such a system, high road lenders will face a level playing field; competition and innovation will benefit customers. This is much like the need for a referee in any sport. If there are no referees, dirty players cheat and good players lose or must follow suit. It's not a foul unless a referee calls it. A good referee applying sensible rules can ensure that all players—honest and dishonest—play by the same rules. At the same time, the referee must let players play the game and not interfere too often. I believe appropriately implemented the Consumer Financial Products Agency (CFPA) can be like a good referee for the financial sector. It can ensure that firms compete on a level playing field. It can allow players to play the game as long as they are within the bounds of the rules.

As Michael Barr, Eldar Shafir, and I have proposed, a two-part approach to regulation is particularly important to accomplishing this goal.[4] Some financial products—call them first choice products—are easily understood and easy to choose between. First choice products are regulated minimally: ensure disclosure, prevent fraud; we know how to do this, do much of it already and know how to do more of it. But notice this is not enough.

This is because other products—option ARMs, subprime ARMs with interest rates set to increase substantially—can pose significant risks for the typical consumer. They allow bad choices and for low road lenders to enter. These exotic products may make sense for some sophisticated consumers of course. But unchecked they are dangerous because their superficial appeal—with hidden risks—makes them unfair competition for the first choice products. These products would need to be regulated far more stringently. The Federal Reserve, for example, has put forward fact sheets that might serve as disclosure for more exotic mortgages.[5] While a good start to what can be done this is not enough. New products appear all the time, and marketing can be endlessly inventive in sidestepping disclosure. As a result, an agency like the CFPA would need to constantly update as the product mix changes. Done correctly, it would assure that customers could access exotic products. But they

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[2] See *http://johncbogle.com/wordpress/wp-content/uploads/2009/03/iacompliance2.pdf.*

[3] See *http://www.marketintelligencereports.com.*

[4] Michael Barr, Sendhil Mullainathan, and Eldar Shafir, "Behaviorally Informed Home Mortgage Regulation", In *Borrowing To Live: Consumer and Mortgage Credit Revisited,* eds. N. Retsinas and E. Belsky, 170–202. Washington, DC: Brookings Institution Press, 2008. Also see "Behaviorally Informed Financial Services Regulation." New America Foundation, 2008.

[5] See *http://www.federalreserve.gov/newsevents/press/bcreg/20070531b.htm.*

would do so with a greater understanding that their superficial attractiveness comes laden with hidden risks.

This is analogous to how we regulate drugs. Those with minimal risks that consumers understand—ibuprofen, cold medicine—are regulated only to prevent fraud and malfeasance. More complicated drugs—powerful antibiotics—are more stringently regulated. Testing mechanisms ensure efficacy. Independent advisors—a prescriber—ensure those who receive them understand their purposes and risks. In short, we create a fence around a set of products within which firms can compete freely. Outside of this fence, for the more exotic products, there is greater regulation. Individuals taking a door through the fence would know they are moving to a less safe suite of products.

A few points are worth noting about this two-part approach.

- The vast majority of the market is already inside the fence. For example, Freddie Mac reports that fixed rate mortgages made up 67–75 percent of applications in 2006.[6] First choice products of course would include more than just fixed rate mortgages and not all fixed rates (because we do not know the LTV or DTI of these mortgages) would be first choice. Still this number gives us the sense that most products offered would likely fall into the first rate category. So such regulation would in fact help most lenders; it would insulate them from competition by low road products, which would now sit outside the fence facing higher scrutiny.
- It is not necessary to mandate the offer of first choice or vanilla products. Done correctly, the ring-fenced area will be made attractive enough that firms will—as they do now—want to offer products there. The challenge here is to ensure sufficient safeguards for the nonfirst choice products. Otherwise high road firms wanting to offer good products will once again face unfair competition from bad products.
- There are several precedents for this type of two-part approach. Individuals wishing to trade options or other sophisticated products must initially complete more paperwork and are given greater warnings of their dangers. In July 2008, the Federal Reserve placed higher-priced mortgages (which include all loans in the subprime market but excludes nearly all prime market loans) under far greater scrutiny such as a greater requirement for income verification, an explicit affordability requirement, ad higher-than-normal penalties for violation of these requirements. I understand that the authority for this regulation would permit the Federal Reserve, or the CFPA, to place other mortgages, such as option ARMs, in this category of mortgages that receive greater scrutiny and higher penalties.[7]
- For credit cards, Rep. Hensarling (R-Texas) has proposed a close cousin in the form of an amendment to the bill that eventually became the Credit Card Act in 2009. For potentially harmful features, as long as all of a lender's customers are offered a card without the feature, allow customers to opt-in to one with the feature. By ensuring the opt-in includes sufficient warnings, the CFPA could allow exactly this type of door in the fence between first choice and more exotic products. In this particular case, Congress' judgment was that the "first choice" approach would not work to protect consumers, and that a ban of these features was necessary. I believe, however, that it is important for the CFPA to have the first choice tool as an alternative to outright bans even if in some cases the ban is used.
- Private firms already realize the value of clarifying and simplifying choice. Charles Schwab for example has created a category of "Select Funds" which are prescreened for loads, fees and other qualitative criteria.[8] Of course, no firm can control the choice set offered by the entire market; however well structured one firms' choice set is, it sits and competes with other firms' offerings.

For such an approach to be successful there must be a transparent, predictable process by which products become first choice. First choice is not a one-size fits all solution. Since it aims to facilitate choice by customers, first choice products must

[6] See *http://www.freddiemac.com/news/finance/refi-arm_archives.htm.*

[7] See *http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm.*

[8] "Schwab's Income Select List was developed and is managed by the Schwab Center for Financial Research (SCFR) experts and includes mutual funds that have met their rigorous criteria, including both quantitative and qualitative factors. All are no-load and no-transaction fee and are selected based on their ability to generate income in their respective asset classes. The list is designed to help you achieve income and growth." *http://www.schwab.wallst.com/retail/public/research/mutualfunds/oneSource.asp.*

include a suite of products. Who decides what is in this suite? On what basis? This is especially important as we look forward to the financial innovations that are surely on the horizon. A transparent, predictable will give lenders who create a good product comfort that they can reap rewards from it. I believe such a process can be put in place. At the very least this ought to be one of the injunctions to the CFPA to develop and codify this process.

Conclusion

The financial crisis has lain bare the dangers of bad financial products and generated a strong and understandable impetus for consumer protection. I believe that the research on behavioral economics gives guidance on how best to express this urge. The challenge is to provide protection while promoting healthy market competition. The two-part approach in the proposed legislation accomplishes this by providing an attractive tool that is an alternative to bans and mandates.

On the one hand, the proposed CFPA would regulate strongly the most exotic products. On the other hand, vanilla or first choice products—the ones consumers really can choose well between—would be given far greater freedom. This promotes competition and helps high-road firms who operate in the part of the market that the typical consumer operates in. The result I feel will be a financial sector that benefits consumers by allowing them to choose better; that benefits firms by allowing good firms to not be undercut by bad firms offering bad products and that benefits sophisticated consumers by still letting them access more exotic products on the other side of the fence.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM MICHAEL S. BARR

Q.1. *Correcting Incentives*—We have heard a number of reports of how financial sector employees are incentivized to push harmful financial products on to customers—sometimes to keep their jobs. For example, one Bank of America call-center worker claimed, "the more money [she] sold [a customer] and the higher the rate, the more money [she] made. That's what the bank rewards—sales, not service." These products harmed not just customers but the entire U.S. economy. The President's plan recognizes that "an important component of risk management involves properly aligning incentives, and that properly designed compensation practices for both executives and employees are a necessary part of ensuring safety and soundness in the financial sector."[1] Secondly, it suggests the creation of a whistleblower fund, saying that "financial firms and public companies should be accountable to their clients and investors by expanding protections for whistleblowers."[2] This raises two questions:

How could a Consumer Financial Protection Agency ensure that employees are not provided with these incentives to push negative financial products onto customers?

A.1. The Consumer Financial Protection Agency (CFPA) will have the authority and tools to address practices that harm consumers in the marketplace for consumer financial products and services. This authority would extend to business practices, including compensation practices that push consumers to purchase inappropriate products and services.

The authority the CFPA would have to address harmful employee incentive practices includes, for example, the following: Under Section 1031, the CFPA could issue rules to restrict unfair, deceptive or abusive acts and practices. The CFPA will also have the authority, under Section 1033, to promulgate rules regarding sales practices, to ensure that consumer financial products and services are provided in a manner, setting and circumstances which ensure that the risks, costs, and benefits of the products or services are fully and accurately represented to consumers. In addition, under Section 1037, the CFPA will have the authority to prescribe rules imposing duties on a covered person, or an employee of a covered person, who deals directly with consumers in providing financial products and services, as the CFPA deems appropriate to ensure fair dealing with consumers. With this authority, the CFPA will be able to impose duties on salespeople and mortgage brokers to offer appropriate loans, take care with the financial advice they offer, and meet the duty of best execution. The CFPA also would be able to prevent lenders from paying higher commissions to brokers or salespeople (yield spread premiums) for selling loans to consumers with higher rates than consumers qualify for.

Q.2. Would the Consumer Financial Protection Agency play any role in protecting whistleblowers who call attention to abuses against consumers, much like the whistleblower protections given

[1] See *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf,* p. 30.
[2] See *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf,* pp. 15 and 72.

to employees of contractors and State and local governments in this year's stimulus bill?[3]

A.2. Yes, the CFPA will play a role in protecting whistleblowers who call attention to abuses against consumers. Section 1057 provides protections for employees who, among other things, provide information to the Agency or testify in any proceeding resulting from the enforcement of the CFPA Act. Employees who believe they have been terminated or otherwise discriminated against because of the information they have provided have a right to review by the Agency of such action, including a right to a public hearing as part of the required investigation by the Agency. After investigation, the Agency has the authority to issue an order which provides for reinstating or rehiring the employee.

Q.3. *Senators Wyden and Whitehouse's Amendments From the Credit Card Bill*—Earlier this year when the Credit Card Accountability, Responsibility and Disclosure Act was on the Senate floor, Senator Wyden and Senator Whitehouse each had an amendment that ultimately did not get incorporated into the final legislation. Senator Wyden's amendment would have established a five-star rating system for credit cards, and Senator Whitehouse's amendment would have overturned the Supreme Court's *Marquette* decision that allowed interest rates to be exported across State lines.

How would your proposal deal with the issues that these two amendments sought to address? Would the proposal allow the Consumer Financial Protection Agency to set up some type of rating system for credit cards to the extent it determines necessary to protect cardholders?

And what effects would your proposal have on the *Marquette* decision?

A.3. The CFPA would have the authority to achieve the same ends as the proposed credit card rating system—fairness and transparency. It is given the mandate to ensure that consumers have the clear and accurate information they need to make responsible financial decisions. Ensuring that consumers have, reasonably can understand, and can use the information they need to make responsible decisions is the first of the CFPA's four objectives under Section 1021(b)(1).

We do not propose to alter existing law under *Marquette,* which allows banks to charge the interest rate permitted by their chartering State.

Q.4. In his testimony, Mr. Yingling cites the Treasury's plan as saying "that 94 percent of high cost mortgages were made outside the traditional banking system," (p. 4). On the other hand, you testify that "about one-half of the subprime originations in 2005 and 2006—the shoddy originations that set off the wave of foreclosures—were by banks and thrifts and their affiliates." Please explain the discrepancy.

A.4. Mr. Yingling's assertion is incorrect. Here is the relevant paragraph from our white paper, Financial Regulatory Reform: A New Foundation (pp. 68–69). *http://10.75.16.79:8080/docs/regs/FinalReport_web.pdf.* See in particular the last sentence.

[3] American Recovery & Reinvestment Act of 2009, Pub. L. No. 111–5, §1553.

> Rigorous application of the Community Reinvestment Act (CRA) should be a core function of the CFPA. Some have attempted to blame the subprime meltdown and financial crisis on the CRA and have argued that the CRA must be weakened in order to restore financial stability. These claims and arguments are without any logical or evidentiary basis. It is not tenable that the CRA could suddenly have caused an explosion in bad subprime loans more than 25 years after its enactment. In fact, enforcement of CRA was weakened during the boom and the worst abuses were made by firms not covered by CRA. Moreover, the Federal Reserve has reported that only 6 percent of all the higher-priced loans were extended by the CRA-covered lenders to lower income borrowers or neighborhoods in the local areas that are the focus of CRA evaluations.

The information from the last sentence is from an article by Federal Reserve economists and refers just to subprime loans made by a bank or thrift (a) to lower-income people or neighborhoods and (b) in a bank or thrift's CRA assessment area. See *http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4136*. This statistic does not refer to the whole population of subprime loan originations. Of that population, banks and thrifts held a significant share.

That fact is evident in Table 1 below (*http://www.minneapolisfed.org/pubs/cd/09-2/table1.pdf.*) from the same article. It shows that, in 2005, 36 percent of higher-priced loans were by depositories or their subsidiaries; in 2006 the figure rose to 41 percent. If you add in bank affiliates, in 2005, banks, their subsidiaries and affiliates made 48 percent of all higher-cost loans, and 54 percent in 2006.

Table 1: Higher-Priced Lending by Institution Type, 2005–2006

Institution Type	2005		2006	
	Distribution of Higher-Priced Loans Across Institution Types (%)	Incidence of Higher-Priced Loans Within Institution Types (%)	Distribution of Higher-Priced Loans Across Institution Types (%)	Incidence of Higher-Priced Loans Within Institution Types (%)
Independent Mortgage Company	52	41	46	42
Depository	23	13	29	19
Subsidiary of Depository	13	21	12	23
Affiliate of Depository	12	31	13	38
Total	100	–	100	–
All*	–	25	–	28

Source: Home Mortgage Disclosure Act (HMDA) data from the Federal Financial Institutions Examination Council. Statistics in the table were calculated using first-lien, conventional, site-built home purchase and refinance originations reported as higher-priced under the HMDA.

Q.5. Mr. Yingling claims that the creation of the CFPA will result in a "potentially massive new regulatory burden." He then goes on to assert "community banks will have greatly increased fees to fund a system that falls disproportionately on them." How do you respond?

A.5. We believe that the Federal regulatory structure for consumer protection needs fundamental reform. We have proposed to consolidate rule-writing, supervision, and enforcement authority under one agency, with marketwide coverage over both nonbanks and banks that provide consumer financial products and services. With

this consolidated authority and marketwide coverage, the CFPA will be able to regulate in a manner that is more streamlined and effective, not more burdensome.

The authorities for rulemaking, supervision, and enforcement for consumer financial products and services are presently scattered among seven different Federal agencies, sometimes with overlapping authority. For example, the Federal Reserve Board (FRB) has jurisdiction over required mortgage disclosures under the Truth in Lending Act (TILA), while the Department of Housing and Urban Development has authority to require mortgage disclosure under the Real Estate and Settlement Protection Act (RESPA). As another example, the Federal Trade Commission (FTC) has authority to issue rules relating to mortgage loans in the nonbank sector, while the Federal Reserve has similar authority under the Home Ownership and Equity Protection Act to issue rules regarding the entire mortgage market. Such balkanization and overlap of regulatory authority does not make sense. With consolidated authority, the CFPA will, for example, be able to integrate the mortgage disclosures required under TILA and RESPA into one, integrated form. This simplification—and others like it—would decrease, not increase, the compliance burden, while improving protections for consumers.

Moreover, with respect to regulations, the CFPA will be statutorily required to consider the potential costs and benefits to consumers and institutions, including the potential reduction in consumer access to financial products and services. The CFPA will be required to consult with safety and soundness regulators before issuing rules. As a result, the CFPA's rules and supervisory approach will be balanced and effective.

It is simply not true under our proposal that community banks will pay higher fees to fund the CFPA. The Administration proposes to provide by statute that community banks will pay no more for Federal consumer protection supervision after the CFPA is created than they do today. Moreover, we believe that community banks will benefit from the CFPA in several ways.

First, today, community banks have to compete against nonbank entities like mortgage brokers and mortgage companies, which, unlike banks, are not subject to Federal oversight. In recent years, nonbank firms won market share by lowering lending standards and offering irresponsible—and often deceptive—loans. Community banks were forced either to lower their own standards or to become uncompetitive. The CFPA will provide a level playing field, extending the reach of Federal oversight to all providers of consumer financial products and services, banks and nonbanks alike, for the first time. The CFPA will put an end to community banks' competitive disadvantage.

Second, CFPA's marketwide coverage and consolidated authority for rule writing, supervision, and enforcement will enable it to choose the least-cost, most-effective tools. For example, it will be able to use "supervisory guidance" in place of new regulations. Supervisory guidance is less burdensome for financial institutions, but is not an effective consumer protection tool today because it requires coordination between numerous Federal and State agencies.

With one Federal agency in charge, supervisory guidance can more often be used in place of new regulations.

Finally, the CFPA will have a mandate to allocate more resources to those companies that pose more risks to consumers when providing consumer financial products and services. Community banks are close to their customers and have often provided simpler, easier-to-understand products with greater care and transparency than other segments of the market. Such banks will receive proportionally less oversight from the CFPA.

Q.6. Mr. Yingling asserts that the CFPA is "instructed to create its own products and mandate that banks offer them. . . . Community banks whether it fits their business model or not, would be required to offer Government-designed products, which would be given preference over their own products." This raises two questions:

Would the Administration's proposal require the CFPA to create its own products?

In the area of mortgages, for example, are the kinds of "plain-vanilla" mortgages that the plan would encourage similar to products that community banks currently offer, or do community banks tend to offer more exotic mortgages that might attract the additional scrutiny contemplated by the proposal? What about nonmortgage products such as credit cards, auto loans, and the like?

A.6. The Administration's proposal would not require the CFPA to design products. The proposal would permit the CFPA only to identify a standard product that is commonly provided in the marketplace already, and that is proven, simple, and poses less risk to consumers. In the mortgage context, such standard products would likely include both 30-year, fixed rate mortgages and adjustable rate mortgage (ARM) products.

Most community banks that offer residential mortgages, offer 30-year fixed rate and conventional ARM mortgage products. These loans would generally meet the definition of standard products. Some community banks certainly offered more exotic mortgages such as payment option ARMs or subprime loans with nontraditional features, but those institutions likely offered conventional loans too.

The mortgage market has known standard products for years. The Agency would have the authority to determine if the concept would also apply in other contexts, such as credit cards and auto loans. Recently at least one major card issuer has offered a "plain-vanilla" credit card and it is possible that this practice would spread.

Q.7. Had lenders been required to offer "plain-vanilla" mortgage products such as fixed-rate mortgages or traditional ARMs during the significant growth in subprime lending starting in 2003, what impact do you think it might have had on the crisis?

A.7. Subprime mortgages grew extremely rapidly, reaching $600 billion in originations and 20 percent of the market by 2005. It is clear today that the rapid development of this segment of the market was disastrous; a Federal Reserve economist has projected that approximately 45 percent of subprime loans originated in 2006 and 2007 will end in foreclosure. A substantial proportion of subprime

borrowers qualified for much safer conventional, standard mortgages, which had lower interest rates, stable payments, escrows for taxes and insurance, no barriers to exit such as prepayment penalties, and substantially lower default rates. The financial incentives for originators, however, were to steer borrowers into subprime loans even if borrowers qualified for conventional loans.

A requirement to provide the consumer a comparison between these more complex products and simpler products might have made a difference. The banking agencies ultimately required lenders to disclose these comparisons, but the agencies took so long to agree on the disclosures that they made little difference.

Q.8. Chairman Bernanke appeared before the Committee on July 23 to discuss monetary policy. At that hearing, he was asked about the requirement that consumers be offered "plain-vanilla" choices. Bernanke said "there is some economic analysis which suggests that there might be benefits in some cases of having a basic product available, so-called 'vanilla product'." He goes on to say, however, that the regulators would have to take care not to "roll back all of the innovation in financial markets that has taken place over the past three decades or so." Do you have any observations to make regarding these comments by Chairman Bernanke?

A.8. Chairman Bernanke's comments are well taken. Our specific proposal on "plain vanilla" is lighter touch regulation. A vanilla product would serve to provide a standard of comparison for borrowers, so they can make more informed choices about what loan product would be best for them. It is another tool besides disclosure, but less intrusive than outright banning contract terms that harm consumers (as Congress just did on credit cards). Our proposal would not dictate business plans or decide for consumers what products are right for them. The goal is to make it easier for consumers who want to choose simple products to make that choice, and to make sure consumers who choose more complicated products understand the risks they are taking.

Here's an example. When the regulators put out a model disclosure on subprime mortgages in 2008, it required mortgage lenders to compare the payment schedule of a subprime mortgage—with a big jump in interest rates in the third or fourth year—to the payment schedule on a fixed-rate, 30-year mortgage. That's the sort of action this agency would take. Only, it would be able to act much faster—the regulators' disclosure came out after the subprime mortgage market had imploded.

I also agree with Chairman Bernanke on innovation. Our proposals are designed to preserve the incentives and opportunities for innovation. Many of the consumer lending practices that led to this crisis gave innovation a bad name and served simply to hide costs in a deceptive manner. We need to create an agency that restores confidence of consumers in innovation. We also need to restore confidence of the financial investors who would fund innovation but have become wary of it. This is why preserving innovation and promoting access are key objectives of the agency. The agency will be required to measure every proposal against these objectives.

Innovation has to be sustainable and respond to consumer preferences. That requires transparency and fairness. We are equip-

ping the agency with the authority to ensure transparency and fairness so that sustainable innovations can thrive.

Q.9. Mr. Wallison argued at the hearing that the Administration's proposal would require lenders to determine the ability of a potential customer to understand various products, which, he goes on to assert will lead to limitations on what they offer. How do you respond?

A.9. The intent of the standard products provision is to provide a standard of comparison for borrowers, so they can make more informed choices about what loan product would be best for them. The Agency will also improve disclosures so that it will be easier for consumers to understand the loan products they are getting. It will remain the consumer's right and responsibility to make the choice.

Q.10. Mr. Wallison said during the hearing that the liability faced by lenders for offering more complex products would effectively eliminate those options for consumers. How do you respond?

A.10. A standard product would serve to provide a standard of comparison for borrowers, so they can make more informed choices about what loan product would be best for them. It's another tool besides disclosure, but less intrusive than outright banning complex contract terms (as Congress just did on credit cards). Since borrowers would be entirely free to select alternative, more complex products and many would do so, lenders would have substantial incentives to offer them.

Q.11. Title X, section 1022(b)(2)(A) of the Administration's proposal describes special rulemaking requirements applicable to the Consumer Financial Products Agency (CFPA). These requirements state that when engaged in a rulemaking, the CFPA must "consider the potential benefits and costs to consumers and covered persons, including the potential reduction of consumers' access to consumer financial products or services, resulting from such rule."

Please explain the rationale for requiring the CFPA to conduct additional analysis beyond the typical notice and comment procedures required of agencies engaged in a rulemaking under the Administrative Procedures Act.

A.11. The goal of the CFPA is not more regulation, but smarter regulation. There is no question that existing consumer protection statutes and rules were not protective enough of consumers, and we are all paying a price for that failure. Better rules are needed. An essential part of the solution is one agency, with marketwide reach, and consolidated authorities of rule writing, supervision, and enforcement.

These rules must be balanced. Supervising and, when necessary, enforcing against banks and nonbanks will provide the new agency with essential information about which problems to address, as well as market realities in banks and credit unions that need to be respected. CFPA will consult with prudential supervisors before writing rules, and the national bank supervisor will be on the CFPA board.

The CFPA proposal requires that the Agency weigh costs in addition to benefits, and consider impact on businesses as well as ac-

cess to credit, in order to ensure that it is a balanced agency that acts in the most effective, prudent way possible. This requirement is consistent with the Agency's mission of not removing all risk from consumer financial products and services, but rather providing consumers with clear and unbiased information that permits them to make their own decisions and weigh their own costs and benefits in a reasoned manner. It is also the practice the Federal Reserve has followed in implementing the consumer financial protection statutes.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM MICHAEL S. BARR

Q.1. The Treasury's "white paper" on financial regulation notes that one of the key goals of the consumer protection agency is to establish consistent regulation of financial products. In fact, the paper notes that "[State insurance regulation] has led to a lack of uniformity and reduced competition across State and international boundaries, resulting in inefficiency, reduced product innovation, and higher costs for consumers." However, the bill forwarded to Congress permits States to add additional and different consumer protection standards for financial products. Does this undercut the goal of consistent regulation? Should not all consumers have the same protection regardless of where they reside? Why not simply direct the new agency to write strong rules in the first place? This ensures consumer protection, yet avoids potential for conflict, confusion, and cost.

A.1. Since the adoption of the first major Federal financial consumer protection law in 1969, the Truth in Lending Act, Congress has with limited exceptions explicitly allowed the States to adopt laws to protect financial consumers so long as these laws do not conflict with Federal statutes or regulations. Federal law thus establishes a floor, not a ceiling. We propose to preserve that arrangement. It reflects a decades-long judgment of Congress, which we share, that States should retain authority to protect the welfare of their citizens with respect to consumer financial services. Federal law ensures all citizens a minimum standard of protection wherever they reside. Citizens of a State, however, should be able to provide themselves—through their legislators and governors—more protection.

The continued ability of citizens to protect themselves through their States is crucial to ensuring a strong Federal standard. State initiatives can be an important signal to Congress and Federal regulators of a need for action at the Federal level. Even with the best of intentions and the best of staff, it is impossible to simply mandate that Federal laws or rules remain updated, since practices change so quickly. States are much closer to abuses as they develop and they are able to move more quickly when necessary. For example, a number of States were far ahead of the Federal Government in regulating subprime mortgages. If States were not permitted to take the initiative to enact laws providing greater protection for consumers, the Federal Government would lose a critical source of information and incentive to adjust standards over time to address emerging issues.

If the Consumer Financial Protection Agency (CFPA) is created and endowed with the authorities we have proposed, we expect the standards adopted by the Agency will promote regulatory consistency, even while it respects the role of the States.

We believe a strong and independent CFPA that is assigned a clear mission to keep protections up-to-date with changes in the marketplace will reduce the incentives for State action and increase legal uniformity. If States retain the ability to protect their citizens as new consumer protection problems appear and the CFPA has the authority it needs to follow the market and keep Federal protections up-to-date, then the CFPA will be more likely to set a high standard that will satisfy a substantial majority of States.

To be sure, federally chartered institutions have recently enjoyed immunity from certain State consumer protection laws. We propose to change that to ensure a level playing field. National banks must already comply with a host of State laws, such as those dealing with foreclosures, debt collection, and discrimination. Under our proposal, federally chartered depository institutions and their State-incorporated subsidiaries would be subject to nondiscriminatory State consumer protection to the same extent as other financial institutions.

We would preserve preemption where it is critical to the Federal charter. Our proposal explicitly does not permit the States to discriminate against federally chartered institutions. Discriminatory State laws would continue to be preempted. Moreover, we do not seek to overturn preemption of State laws limiting interest rates and fees (the *Smiley* and *Marquette* decisions). Nor do we seek to disturb the exclusive authority of the national bank prudential supervisor over national banks with respect to prudential regulation and supervision. Thus, we would preserve the value of the national bank charter.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM MICHAEL S. BARR

Q.1. Mr. Barr, do you agree with Sheila Bair, Chair of the Federal Deposit Insurance Corporation, that safety and soundness cannot be separated from consumer protection?

A.1. I agree with Ms. Bair and other regulators who have testified that safety and soundness and consumer protection need not conflict. Following all applicable laws, including consumer protection laws, is a requirement of a safe and sound institution. And as we've seen in the mortgage and credit card markets, poor treatment of consumers actually undermines the safety and soundness of financial institutions. I think, however, that these complementarities can be preserved with separate agencies. Two banking agencies today, including the FDIC, typically conduct their consumer compliance and safety and soundness examinations with separate teams of examiners. It is a further step to separate the examiners into different agencies, but we would propose to require the CFPA and the prudential agencies to communicate and coordinate closely, and to share examination reports. Ultimately, we believe the complementarities will be strengthened if the CFPA is

given the mandate and authority, as we propose, to identify questionable practices and provide the market and institutions clear rules of the road. The CFPA can help the prudential regulator identify practices that exploit consumer confusion for short-term profits but undermine bank earnings and reputations in the long run.

Q.2. Appearing before the House Energy and Commerce Committee, you said that this new agency would not set prices, dictate what products could be offered, or regulate a firm's advertising practices. Section 1039 of the President's proposals states that, "It shall be unlawful for any person to advertise, market, offer, sell, enforce, or attempt to enforce, any term, agreement, change in terms, fee or charge in connection with a consumer financial product or service that is not in conformity with this title or applicable rule or order issued by the Agency." How do you explain this discrepancy?

A.2. In my testimony before the House Energy and Commerce Committee on July 8, I did state that the CFPA would not set prices. Section 1022(g) of the legislation specifically forbids the CFPA from establishing usury limits. I also stated correctly that the CFPA could not dictate what products firms could offer. With respect, however, I did not testify that the CFPA would not regulate the advertising practices of those offering financial products and services to consumers. Advertising regulations have long been a core element of Federal consumer protection statutes such as the Truth in Lending Act. Regrettably these regulations were not kept up-to-date. Indeed, before the mortgage market collapsed, the marketplace was awash with misleading advertising about low-rate mortgage loans, credit cards, or financial products. Accordingly, the CFPA would have authority, as you note, to regulate advertising practices of persons that provide consumer financial products and services to prevent incomplete or misleading information from undermining competition.

Q.3. In the past, Mr. Barr, you've argued that derivation from a standard, plain-vanilla product "would require heightened disclosures and additional legal exposure for lenders." Please explain why this would, or would not, discourage lenders from offering any products that are deemed unstandard or outside of the agency's safe harbor?

A.3. A standard product would serve to provide a standard of comparison for borrowers, so they can make more informed choices about what loan product would be best for them. It's another tool besides disclosure, but less intrusive than outright banning complex contract terms (as Congress just did on credit cards). Since borrowers would be entirely free to select alternative, more complex products and many would do so, lenders would have substantial incentives to offer them.

Q.4. How much latitude would this new agency have over determining what is a "consumer financial product or service?" The President's proposal says "any financial product or service to be used by a consumer primarily for personal, family, or household

purposes." Could agency have authority over small business loans or commercial real estate?

A.4. As you note, the definition of "consumer financial product or service" in the CFPA Act is limited to any "financial product or service to be used by a consumer primarily for personal, family or household purposes." In applying that language, the CFPA would need to determine whether the product or service is used "primarily" for personal, family or household purposes as a factual matter.

Similar language appears in the definitions of several other consumer protection statutes, including the Truth in Lending Act (15 U.S.C. 1602(h)), the Electronic Funds Transfer Act (15 U.S.C. 1693a(2)), the Fair Debt Collection Practices Act (15 U.S.C. 1692a(5)), the Fair Credit Reporting Act (15 U.S.C. 1681a(d)(1)(A)), and the Equal Credit Opportunity Act (12 CFR 202.2(h)), which implements 15 U.S.C. 1691, *et seq.*). The use of such language is generally understood as meaning to exclude business credit.

As a general matter, under the new authority granted to the CFPA under the CFPA Act, the CFPA would not have authority over small business loans or commercial real estate loans. However, the Equal Credit Opportunity Act (ECOA) prohibits discrimination against certain protected classes in lending for business as well as personal and household purposes, and the proposal would grant the CFPA rulemaking and enforcement authority under the ECOA. To that extent, the CFPA would have authority over business loans under the ECOA.

Q.5. How did the Treasury determine that the Securities and Exchange Commission has done an adequate job protecting consumers? For example, many of Allan Stanford's victims were everyday people, not large, sophisticated institutional investors.

A.5. In establishing a regulatory framework for the protection of consumers and investors, the Administration's goal was for there to be a Federal agency with the mission of consumer protection. In the consumer financial products and services area, this agency is lacking; in the nonbank sector, no Federal agency has supervision and examination authority, regardless of the mission, and in the banking sector, five different agencies share this responsibility but each has safety and soundness as its primary mission. The Securities and Exchange Commission (SEC), on the other hand, does have as its mission the protection of retail investors, so there was no need to duplicate this responsibility within the CFPA. As the SEC has acknowledged with respect to the Stanford and Madoff cases, existing authority should have been sufficient to address these frauds much earlier. The SEC needs additional authorities, however, to provide the broader and more effective oversight that is needed, and that is why the Administration proposes strengthening the agency's authority in several important ways.

Q.6. Should one of the goals of the CFPA be to "optimize household behavior"? What do you think optimal savings means?

A.6. The CFPA will not optimize household behavior. It is for every family to make its own financial decisions. In order to help families make responsible decisions, the CFPA will work to ensure that markets are transparent, people have the information they need

about their financial decisions, and bank and nonbank firms alike follow clear rules of the road.

For many years, until the current recession, the personal saving rate in the United States has been exceedingly low. In addition, tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement. In order to address this problem, the President has proposed two innovative initiatives in his 2010 Budget: (1) introducing an "Automatic IRA" (with opt-out) for employees whose employers do not offer a plan; and (2) increasing tax incentives for retirement savings for families that earn less than $65,000 by modifying the "saver's credit" and making it refundable. The proposals would offer a meaningful saving incentive to tens of millions of additional households while simplifying the current complex structure of the credit and raising the eligibility income threshold to cover millions of additional moderate-income taxpayers.

Q.7. Mr. Barr, do you believe that the Government should steer people's choices in directions that will "improve their lives" or should the Government allow consumers to make their own choices free of interference or direction?

A.7. We believe that it is the responsibility of consumers to make their own decisions on financial matters. There must be clear rules of the road so that firms do not deceive consumers by hiding the true costs of products. The CFPA will create a level playing field with high standards for all firms, bank and nonbank alike, which means that the marketplace will provide a broader array of high quality products from which consumers can freely choose.

Q.8. Do you believe that it is more profitable for a bank to issue a mortgage or credit card loan to a customer who defaults or to one who makes their payments?

A.8. If incentives are properly aligned, banks should make as much or more money when a mortgage or credit card borrower pays their loan as when they default. Problems arise, however, when markets are structured so that the bank is indifferent to future loan performance, as when the lender immediately sells the loan into an investment conduit without retaining any of the risk of default. This "originate to distribute" model caused incentives to deviate. The lenders—the parties in the best position to determine the creditworthiness of the borrowers—had no incentive to carefully underwrite; they were paid up front when the loan was made regardless of future performance. That is why the Administration proposes that originators of loans or the securitizer must retain 5 percent of the credit risk associated with loans sold into a conduit.

Q.9. Will you please define what an "objective reasonableness standard" means?

A.9. Disclosure mandates for consumer credit and other financial products are typically very technical and detailed, and it takes time for regulators to update them because of the need for consumer testing and public input. The growth in the types of risks stemming from new and complex credit card plans and mortgages that preceded the credit crisis far outpaced the ability of disclosure regulations to keep up. We propose a regime strict enough to keep disclo-

sures standard throughout the marketplace, yet flexible enough to adapt to new products. Our proposed legislation authorizes the CFPA to prescribe rules that require disclosures and communications to be reasonable, not merely technically compliant. The proposal is based in part on the banking agencies' supervisory guidance on subprime and nontraditional mortgages. This guidance requires originators to make balanced disclosures.

Q.10. If a financial institution developed a new product today, under the CFPA would that product be able to be brought to the marketplace tomorrow? What will financial institutions be required to do before introducing a new product?

A.10. If a financial institution developed a new product today, under the CFPA Act that product could be offered in the market tomorrow—the CFPA will not be approving financial products. Of course, all products must comply with existing laws. For example, credit cards may not contain terms, such as retroactive rate increases, that would violate the Credit CARD Act of 2009. It is the institution's responsibility to determine that a new product complies with applicable laws before the institution brings the product to the market. It is CFPA's role to help ensure that products offered in the market comply with applicable laws, and to take appropriate steps if a product does not.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM EDWARD L. YINGLING

Q.1. In assessing the need for and scope of a new Consumer Financial Protection Agency (CFPA), the Committee must conduct an objective evaluation regarding the responsibility of various types of financial services providers for the lending problems that have occurred in recent years. In your written testimony, you identify nonbank lenders as the source for the vast majority of abusive mortgage lending in recent years. Specifically you write that " . . . the Treasury's plan noted that 94 percent of high cost mortgages were made outside the traditional banking system." Your testimony also says that " . . . it is likely that an even higher percent of the most abusive loans were made outside our sector."

On the other hand, the Committee heard testimony from Professor McCoy of the University of Connecticut on March 3, 2009, that such an assertion, "fails to mention that national banks moved aggressively into Alt-A low-documentation and no-documentation loans during the housing boom." Professor McCoy cites data indicating that national banks and thrifts issued mortgage loans from 2006–2008 with higher default rates than State-chartered thrifts and banks. Moreover, Assistant Secretary Barr testified on the panel prior to you that "about one-half of the subprime originations in 2005 and 2006—the shoddy that set off the wave of foreclosures—were by banks and thrifts and their affiliates."

Is it your view that national banks and thrifts did not play a significant role, either directly or through their subsidiaries, in offering abusive or unsustainable mortgage loans?

A.1. Thank you for your question, Mr. Chairman. Certainly, some banks—both national and State chartered—were involved in

subprime lending, but the fundamental fact remains that the vast majority of banks in the country never made a toxic subprime loan. These regulated banks did not cause the problem; rather, they are the solution to the economic problem we face.

The comment by Professor McCoy you cite in your question is not directed at the Treasury's statistic we referenced, *i.e.,* that a very high percentage of high cost loans were made outside the banking industry. In fact, Professor McCoy refers to a study by the OCC which finds that national banks only accounted for 10 percent of subprime lending in 2006—thus confirming the evidence that the heart of the problem is with nonbanks.

Even though attempts have been made to increase Federal regulation of the nonbank sector, the fact remains that in the key areas of examination and enforcement, nonbanks still are not regulated as strictly or robustly as banks. In fact, the GAO recently released a study on Fair Lending (July 2009) which found that the independent mortgage lenders represented "higher fair lending risks than depository institutions" yet "Federal reviews of their activities are limited." Furthermore, GAO found that "[d]epository institution regulators also have established varying policies to help ensure that many lenders not identified through HMDA screening routinely undergo compliance examinations, which may include fair lending components." This increased focus on insured depository institutions occurs because the banking agencies "have large examination staffs and other personnel to carry out fair lending oversight."

Traditional banks are the survivors of this financial crisis, not the cause. The fly-by-night nonbank mortgage lenders have disappeared as fast as they appeared. As I mentioned in detail in my written statement, the focus of policymaking should be on the core cause of the problem—the unregulated nonbank financial sector—and not end up punishing the very institutions that are most likely to restart our economy.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM TRAVIS B. PLUNKETT

Q.1. Both Mr. Yingling and Mr. Wallison testified repeatedly that the Administration's plan would result in credit being rationed to consumers, particularly consumers who need the credit the most. They also argued that the requirement that additional disclosures or warnings accompany products that are not "plain-vanilla" products would result in only those standard products being offered. Specifically, Mr. Wallison testified that " . . . when a provider is confronted with the choice of whether to offer only the plain-vanilla product or the more complex product, he has to decide whether this particular consumer is going to be able to understand the product." Because lenders will be reluctant to make such judgments, they will, by default, offer the plain-vanilla product only, thereby constraining consumer choices. How do you respond to these arguments?

A.1. Poor regulation of abusive credit products by Federal regulators over many years has led to exactly the result that Mr. Yingling and Mr. Wallison are concerned about: credit rationing.

Deceptive and unsustainable lending practices by credit card companies and mortgage lenders led to record defaults and foreclosures by consumers, record losses by lenders, a crisis in the housing markets and the recession. These developments, in turn, have led to a "credit crunch" where credit card lenders, for example, have significantly reduced credit lines and sharply increase interest rates, even for borrowers with stellar credit scores. Had a Consumer Financial Protection Agency existed to prevent the excesses that occurred in the lending markets, there is a very good chance that this country could have avoided the worst aspects of the housing and economic crisis, and of the somewhat indiscriminate reduction in credit availability that has occurred. In other words, proper regulation will create the kind of stability in the credit markets that encourages lenders to offer credit to consumers, especially those who do not have perfect credit ratings.

Similarly, the "plain-vanilla" requirement is designed to create choices in the credit marketplace that don't exist now, and certainly did not exist during the credit boom. "Choices," such as prepayment penalties that lock consumers into unaffordable loans and "exploding ARM" loans that lenders knew many of their borrowers could not afford, crowded out less abusive options from the marketplace and ultimately harmed consumers and the economy. Lenders are quite capable of designing simple, understandable financial products that are profitable for them and useful for consumers, if they chose to do so.