

## Testimony of Ellen Seidman, Senior Fellow, New America Foundation, Before the Financial Services Committee United States House of Representatives

JUNE 24, 2009

Chairman Frank, Ranking Member Bachus and members of the Committee: I appreciate your inviting me here this morning to discuss consumer protection and oversight in the financial services industry in the context of the current economic crisis, and to provide my thoughts on how the regulatory system should be restructured to enhance consumer protection in the future. My name is Ellen Seidman, and I am a Senior Fellow at the New America Foundation. I also serve as Executive Vice President, National Program and Partnership Development, at ShoreBank Corporation, the nation's first and leading community development bank holding company, based in Chicago. The views expressed here are my own, and not those of New America or ShoreBank.

Last week, the Administration proposed creation of a very broad-based and powerful Consumer Financial Protection Agency (CFPA) that would have regulatory, supervisory and enforcement authority over consumer protection in the financial services sector and also over the Community Reinvestment Act (CRA).<sup>1</sup> The Administration's recognition of the seminal importance of consumer protection in financial services is a critical reversal of the trends of the last several decades. I agree with the Administration that the time has come to create a well-funded single federal entity with the responsibility and authority to receive and act on consumer complaints about financial services and to adopt consumer protection regulations that would be applicable to all providers of financial services, and applaud the Administration's bold stroke.

The Administration has also focused on the importance of the CRA. As the Administration's proposal recognizes, access to high quality financial products, at fair terms and reasonable prices, is an essential element of consumer protection. When well-regulated entities do not provide quality services that meet needs and are well-marketed, expensive and sometimes predatory substitutes will move in. Avoiding that result requires both leveling the playing field by having consistent regulations, well-enforced, across all entities providing similar products and encouraging financial institutions to serve all communities and consumers.

I am, nevertheless, concerned about two elements of the Administration's proposal, as discussed below. First, I believe that prudential supervisors, in particular the federal and state banking regulatory agencies, should retain primary supervisory responsibility for consumer protection, as well as for safety and soundness, over the entities they regulate. I suggest, however that Congress make some changes to the organic banking statutes to emphasize the importance of consumer protection, elevating it to a higher place in the supervisory system. Second, I am concerned, that what has been in many ways the most consistently successful element of the CRA, namely investment in community development finance (such as affordable rental housing, community facilities, small business lending both with and through Community Development Financial Institutions) may get lost in an agency devoted to consumer protection. This could hurt the communities in which many of those consumers most in need of protection live. Later in the testimony, I suggest some ways to increase the likelihood that if CRA is part of the CFPA, service to all communities and community development will be a robust part of its mandate.

---

<sup>1</sup> Department of the Treasury, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," June 2009, available at [http://financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://financialstability.gov/docs/regs/FinalReport_web.pdf), hereafter "Proposal." The section of the proposal dealing with consumer protection is at pages 55-70.

My testimony starts by explaining how my experience informs my opinion on these issues, provides some background on the source of the crisis, sets out regulatory principles, and then comments on the Administration's proposal and ends with a discussion of CRA in the context of the proposal.

## **HOW MY EXPERIENCE INFORMS MY POSITION**

My views on these topics are informed by my current experience, including service on the Boards of two Community Development Financial Institution loan funds and as Chair of the Board of the Center for Financial Services Innovation,<sup>2</sup> as well as by my years at the Treasury Department, at Fannie Mae, at the National Economic Council under President Clinton, and as Director of the Office of Thrift Supervision from 1997 to 2001.

During my tenure at OTS, we placed significant emphasis on both consumer and compliance issues and on the responsibility of the institutions we regulated to serve the communities in which they were chartered, both because of their obligations under the CRA and because it was good business. We paid particular attention to compliance, building up our staff and examination capability, establishing a special award (done away with by my successor) to honor the best performer in compliance and community affairs, reaching out to consumers and communities, and enhancing our complaint function. In three particular cases during my OTS tenure, concern about consumer issues led directly to safety and soundness improvements. Two involved guidance that got thrifts out of sub-prime monoline credit card lending (just months before that industry got into serious trouble) and payday lending. In another case involving a specific institution, through our compliance examiners' concern about bad credit card practices, we uncovered serious fair lending and safety and soundness issues. We were by no means always successful, but we worked to put compliance on an equal footing with safety and soundness.

Since I left OTS, I have spent much of my time working on issues relating to asset building and banking the underbanked, in which context the importance of consumer protection, for both credit and other products, is plainly apparent. Finally, my years at Fannie Mae and at ShoreBank and the community development work I have been doing have made me both conscious of and extremely sad about what has happened in the mortgage market and the effects it is having on both households and communities.

I believe the bank regulators, given the proper guidance from Congress and the will to act, are quite capable of effectively enforcing consumer protection laws. Moreover, because of the system of prudential supervision, with its on-site examinations, they are also in a good position to do so efficiently and in a manner that benefits both consumers and the safety and soundness of the regulated institutions. Consumer protection can be the canary that gives early warning of safety and soundness issues—but only if someone is paying attention to dying birds.

## **SOURCES OF THE CURRENT CRISIS**

The current crisis has many causes, including an over-reliance on finance to “solve” many of the needs of our citizens. When real incomes stagnate while the cost of housing, health care and education skyrocket, there are really only two possible results: people do without or they become more and more overleveraged. Financial engineering and cheap investor funding, largely from abroad, enabled the overleveraging, but a lack of adequate attention to the manner in which the financial services system interacted with consumers certainly kept the process going and caused consumers and the economy to fall harder when it ended. By 2007, consumer debt was 138% of disposable income, and almost 15% of families devoted more than 40% of their disposable income to paying off debts. After artificially falling in response to revisions to the Bankruptcy Code in 2006, consumer bankruptcy filings have been rising at the rate of 30% a year and reached over 1 million in 2008. Consumers were harmed by both the proliferation of bad products and practices and the sale of hard-to-understand credit and investment products to

---

<sup>2</sup> I serve on the boards of the Low Income Investment Fund ([www.liifund.org](http://www.liifund.org)) and Coastal Enterprises, Inc. ([www.ceimaine.org](http://www.ceimaine.org)). The Center for Financial Services Innovation ([www.cfsinnovation.com](http://www.cfsinnovation.com)) is a non-profit affiliate of ShoreBank that works to transform the financial services marketplace to help underbanked consumers achieve financial prosperity.

customers for whom they were not suitable, and by the lack of high quality products that meet consumer needs, well priced and effectively marketed, especially in lower income communities.

I believe that there were three basic regulatory problems. First, there was a lack of attention, and often unwillingness, to effectively regulate products and practices even where regulatory authority existed. The clearest example of this is the Federal Reserve's unwillingness until recently to regulate predatory mortgage lending under HOEPA. However, as the recent actions by the Federal Reserve, OTS and NCUA have demonstrated, there was also authority under the FTC Act that went unused. Moreover, neither the Federal Reserve nor the OTS—at least until fairly recently—has seriously probed the consumer practices of non-depository subsidiaries of the holding companies they regulate. This is not just an issue at the federal level. While there are certain states—North Carolina, Maryland and Massachusetts prominent among them—that have been aggressive with respect to consumer protection, others, including California, the home of many of the most aggressive mortgage lenders, were not. Capital regulations also played their part; the ability to move badly underwritten products completely off the balance sheet, earning fees for originating them, but holding no capital against them, only encouraged the proliferation of such products.

Second, we need to acknowledge that there were, and are, holes in the regulatory system, both in terms of unregulated entities and products, and in terms of insufficient statutory authority. The clearest case relates to mortgage brokers, where there was no federal regulation at all, no regulation beyond simple registration in many states, and ineffective regulation even in most of the states that actually asserted some regulatory authority. But there are other examples—payday lending is prohibited in some states, regulated more or less effectively in others, and pretty much allowed without restriction in still others. And then of course there is the question of what kind of responsibility sellers of financial products have to customers. We know we have not imposed a fiduciary duty on them, but does that mean there is no responsibility to match customer with product?

Finally, there is and was confusion, for both the regulated entities and consumers and those who work with them. Consumer protection comes in many forms, from substantive prohibitions like usury ceilings and payday lending prohibitions, through required terms and practices, to disclosures and marketing rules. Multiple regulators exacerbate the confusion. At the federal level, there are multiple bank regulators, not to mention the NCUA, the FTC and HUD, and their jurisdiction is frequently overlapping. States and even localities also regulate consumer protection, again often through multiple agencies. And of course, sometimes the federal and state laws overlap.

The system clearly could be improved. But as we do so, we should not be lulled into thinking the solutions are obvious or easy. In general they're not, and I would assert that they are harder and more subtle than is the case with manufactured consumer products. The products, even the good ones, can be extremely complex. Just try describing the lifetime interest rate on a Savings Bond or how a capped ARM works. Or for that matter whether a payday loan or a bounced check is more expensive. Many products, especially loans and investments, involve both uncertainty and difficult math over a long period of time, which is hard for even the most educated consumer. And the differences between a good product and a bad one can be subtle, especially if the consumer doesn't know where to look. An experienced homeowner knows the importance of escrowing insurance and taxes, but the dire consequences of the lack of an escrow are easy for a first-time homebuyer to miss. And a relatively safe ARM can turn into a risky one when caps are removed or a prepayment penalty added.

Finally, different consumers legitimately have different needs. To take the example economists love, when there is a normal, upward sloping yield curve, most homebuyers are better off with a 5-year ARM than with a 30 year fixed rate mortgage. With the long-term loan they are paying a higher interest rate for an option they are unlikely to use, since they will likely move, prepay or refinance long before 30 years are up. But for a consumer whose income is unlikely to increase, who has few other resources, who has difficulty budgeting—or who is just plain risk-averse—the certainty of the fixed rate mortgage may well be worth the additional cost.

## LOOKING FORWARD

Before turning to regulatory issues, I suggest there is a broader social context of change that we need to consider. To what extent can we turn some of the complex, long-term financial obligations that we have foisted on individual consumers—most clearly retirement and health care—back to more collective management? We also should recognize that there is some rate of interest and some level of financial engineering at which the drive for “availability of credit” masks both lack of sufficient income and collateral supports (such as health care) and an insufficient level of financial understanding. We need to educate our children from day one about what money means, how interest rates work, and who to get help from, and we need to create systems of helpers, which can include the internet and things like overdraft alarms, but which also requires low-cost access to people who are competent to give advice and have a fiduciary duty to the consumer.<sup>3</sup>

In this period when consumers are being forced to deleverage and cut back, and are actually beginning to save more on their own accord, we should once again make saving easy and an expected part of life.<sup>4</sup> Having an account at a bank or credit union helps encourage saving, although the account needs to be designed so consumers have the liquidity they need without paying for it through excessive overdraft fees. Tying savings to credit, such as by requiring part of a mortgage payment to go into a savings account for emergencies like repairs or temporary inability to make a payment, can also help. And so would moving toward more savings opt-outs, like payroll deductions for non-restricted savings accounts that can be used in an emergency (as well as for retirement accounts), a concept we are testing at the New America Foundation as AutoSave.

## PRINCIPLES FOR REGULATION

The regulatory framework, of course, involves both how to regulate and who does it. With respect to how, I suggest three guiding principles. First, to the maximum extent possible, products that perform similar functions should be regulated similarly, no matter what they are called or what kind of entity sells them. For example, we know that many people regarded money market mutual funds and federally-insured deposit accounts as interchangeable. Either they are, and both the products and—to the extent the regulation has to do with making sure the money is there when the customer wants it—the regulation should be similar, or they are not and they should not be treated as such, including by regulators who are assessing capital requirements. To take another example, payday loans and bounced check protection have a good deal in common, and probably should be regulated in a similar manner. This also means that a mortgage sold directly through a bank should be subject to the same regulatory scheme and requirements as one sold through a broker. This principle is at the heart of the Administration’s proposal.

Second, we should stop relying on consumer disclosure as the primary method of protecting consumers. While such disclosures can be helpful, they are least helpful where they are needed the most, when products and features are complex. The Federal Reserve’s recognition of this with respect to double cycle credit card billing was a critical breakthrough: by working with consumers, they came to understand that no amount of disclosure was going to enable consumers to understand the practice. The same is true of very complex mortgage products. The “one page disclosure” is great for simple mortgage products, but where there are multiple difficult-to-understand concepts in a single mortgage—indexes and margins, caps on rate increases and on payments, per adjustment and over the loan’s lifetime, escrows or not, prepayment penalties that change over time, option payments and negative amortization, and many different fees—the likelihood is low that any disclosure will enable those for whom these issues really make a difference to understand them. The Administration’s proposal recognizes the principle that disclosure may be helpful, but is unlikely to be sufficient when products are complex, and moreover would require the CFPB to test and evaluate disclosures to make them reasonable and understandable.<sup>5</sup>

---

<sup>3</sup> See Proposal, page 68.

<sup>4</sup> See Proposal, pages 74-75.

<sup>5</sup> Proposal, pages 63-64.

In the last few years, several academics have suggested potential substitutes for disclosure that go beyond the traditional type of prohibitory consumer protection rules. For example, Professor Ronald Mann has suggested that credit card contracts be standardized, with competition allowed on only a few easily-understood terms, such as annual fees and interest rates.<sup>6</sup> In some ways, this is what the situation was with most mortgages well into the 1990s. Professors Michael Barr (now Assistant Secretary of the Treasury for Financial Institutions), Eldar Shafir and Sendil Mullainathan have suggested the development of high quality, easily understood “default” products such as mortgages, credit cards and bank accounts, allowing other products to be sold, but with more negative consequences for sellers if the products go bad, such as requiring the seller to prove that the disclosures were reasonable as a condition to enforcing the contract, including in a mortgage foreclosure action.<sup>7</sup> This is the genesis of the concept in the Administration’s proposal that the CFPB propose and give special protection to “plain vanilla” products with terms that are simple and easy to compare.<sup>8</sup>

Third, enforcement is important. Rules that are not enforced, or not enforced equally across providers, generate both false comfort and confusion, and tend to drive, through market forces, all providers to the practices of the least well regulated. This is in many ways what we have seen with respect to mortgages; it is not just that some entities were not subject to the same rules as others, but also that the rules were not enforced consistently across entities. The Administration proposes to accomplish this by transferring primary federal supervision and enforcement for consumer protection with respect to all depositories into the CFPB. As noted above and discussed below, while this could improve consistency, on balance I think it may not be the most effective result. The Administration’s proposal appears to contemplate that the CFPB would also engage in prudential supervision, i.e., on-site examinations, of state-regulated non-depository institutions, although “the states should be the first line of defense.”<sup>9</sup> Especially if it means that entities not now subject to prudential supervision would be, it could be very large undertaking, given the number and type of institutions involved, but it could also lead to substantial improvements for consumers of the services of non-depositories.

## **ESTABLISHING A CONSUMER FINANCIAL PROTECTION AGENCY**

The time has come to elevate the consistent consideration of consumer protection with respect to financial instruments to the same level of concern as the financial stability of the financial system. Indeed, as the current crisis demonstrates, failure to do so leads to financial instability. As the Administration notes in its proposal, elevating consumer protection requires understanding what consumers need; how products are marketed and sold; how consumers get information about, understand and use products; and the benefits and risks of various products to different consumers. Solving for protection given varied needs and experiences is difficult enough. But solving for protection without also paying attention to meeting needs—for example the liquidity needs of someone living paycheck to paycheck—will just push both providers and consumers into the “informal” sector, a sector that will exist no matter what laws and regulations we enact.<sup>10</sup>

I support the creation of a new, independent Consumer Financial Protection Agency, with rulemaking, enforcement and complaint-collection responsibilities. This would be an independent agency, on the model of the Federal Trade Commission or Consumer Product Safety Commission, with responsibility for (i) receiving and investigating consumer complaints; (ii) writing regulations to enhance the protection of consumers with respect to financial products, practices and features and to enhance access to products that are transparent, simple and fair; and (iii) enforcement of those regulations. The agency should also conduct cutting-edge in-depth research on

---

<sup>6</sup> Ronald Mann, “Contracting’ for Credit,” 104 Mich LR 899 (2006) at 927-28.

<sup>7</sup> Michael Barr, Sendhil Mullainathan, and Eldar Shafir, “A One-Size-Fits-All Solution,” *New York Times*, December 26, 2007, available at <http://www.nytimes.com/2007/12/26/opinion/26barr.html?scp=1&sq=michael percent20barr percent20mortgage&st=cse>. See also Michael Barr, Sendhil Mullainathan, and Eldar Shafir, “Behaviorally Informed Financial Services Regulation” (Washington, DC: New America Foundation, October 2008), available at [http://www.newamerica.net/files/naf\\_behavioral\\_v5.pdf](http://www.newamerica.net/files/naf_behavioral_v5.pdf).

<sup>8</sup> Proposal, pages 66-67.

<sup>9</sup> Proposal, page 59.

<sup>10</sup> Proposal, page 59.

needs, products and practices, the utility of various approaches to protection, and the efficacy of consumer protection regulations. As the Administration has proposed, the initial scope of authority of the CFPA should be consumer credit and related transaction, deposit, payment and savings products,<sup>11</sup> although one might consider extending the scope over time, and as the new agency proves its value. The products named are the most widely used, most likely to cause long-term serious financial difficulties (especially for families with little cushion for loss) and subject to the most checkered and inconsistent regulatory coverage at both the state and federal levels.

### Complaints

There has only been limited focus on the treatment of complaints, but centralizing the consumer complaint function at a single agency is important. While the Administration proposes centralizing complaints related to federally-regulated entities,<sup>12</sup> we would do well to think more broadly. A nationwide complaint function, covering state-regulated, as well as federally-regulated entities would have sufficient scale and focus to make it possible to create a world-class system, easy to use, and effective in serving individuals, helping providers resolve problems, and finding systemic problems. It would provide consumers a single point of contact, rather than requiring them to navigate the complex world of financial services providers and regulators when they have a problem or concern about a financial service or product, and also provide some consistency in response. In addition, the agency would have the tools to recognize, research and respond to developing problems before they threaten the economy—or large numbers of consumers.

### Regulations

With respect to regulations, the mortgage situation has shown that a base level of regulations that all providers must adhere to is a precondition to keeping the market at the level of those engaged in best practices—or at least the practices condoned by the regulators—not the worst. The Administration proposes that the CFPA’s mission “be to help ensure that:

- consumers have the information they need to make responsible financial decisions;
- consumers are protected from abuse, unfairness, deception, or discrimination;
- consumer financial services markets operate fairly and efficiently with ample room for sustainable growth and innovation; and
- traditionally underserved consumers and communities have access to lending, investment and financial services.”<sup>13</sup>

The Administration proposes to unite responsibility for all federal consumer protection laws relating to consumer financial products other than investment products<sup>14</sup> in the new entity. This will ensure regulatory consistency and thus enhance innovation. Moreover, bringing all financial consumer responsibilities together will help provide the scale and scope of regulatory authority to develop expertise and give the CFPA the gravitas and power to attract high quality talent and be taken seriously.<sup>15</sup> Establishing the CFPA while not shifting regulatory responsibility for existing statutes to it might well reduce the interest of current regulators in the field, thus potentially reducing, rather than enhancing, overall consumer protection.

---

<sup>11</sup> Proposal, page 57.

<sup>12</sup> Proposal, page 62.

<sup>13</sup> Proposal, pages 57-58. The proposal also recognizes the importance of compensating the staff on a par with staff of other independent financial regulatory agencies.

<sup>14</sup> Jurisdiction over investment products would remain with the SEC, but a Financial Consumer Coordinating Council would be established to enhance consistent regulation of products that could fall under the jurisdiction of multiple agencies. Proposal, pages 70-74.

<sup>15</sup> Given changes in financial services and technology in the years since some of these statutes were last considered in depth, the CFPA should also be required within a reasonable period to recommend any changes needed in these laws.

The CFPA would be not just be about protection in the “thou should not” sense of the word; indeed, there is emphasis in the Administration’s proposal on the affirmative, on consumers having access to the financial products they need to live their lives fully and that those products are transparent, simple and fair.<sup>16</sup> Access is a concept that extends beyond fair lending and the CRA. It covers issues like understanding how consumers actually use financial products and what kinds of protections and notice consumers value and use. For example, how valuable are monthly paper statements to consumers who run the risk of overdraft at the end of every bi-weekly pay period? Would text alerts be more effective in helping them manage their accounts?<sup>17</sup> By focusing on these issues the CFPA may be able to spur innovation and keep costs down while enhancing consumer protection. The Administration envisions the CFPA having strong research capacity, using data both it and the industry collects to enable it to become expert in consumer understanding and behavior.<sup>18</sup> This can help it regulate effectively without necessarily having a heavy hand.

As I understand the Administration’s proposal, the CFPA would not be required to pre-approve products, although “no action” letters would be available to producers and developers of new products who wanted to be sure their product disclosures met the CFPA’s “reasonableness” standard. I agree that requiring product pre-approval would be a mistake. Financial products are almost infinitely variable, and small variations can make a big difference in safety and effectiveness. Moreover, financial activities consist of practices and processes, as well as products—and sometimes the delivery channel matters more than the product. In addition, technology is generating new opportunities, which can work to consumers’ benefit as well as their detriment, at a very fast pace. In this atmosphere, requiring pre-approval would be a drain on resources and a bar to useful innovation. In addition to the “no action” concept, an alternative to pre-approval that might be useful, especially as to products, would be to require providers to file product descriptions with the new agency, at least with respect to a specified group of products and terms. This could enhance the agency’s ability to stay up-to-date on innovations in the market and potentially to respond to troublesome products or terms before they become widespread.

### *Supervision and Enforcement*

The CFPA should have the authority to enforce its regulations—and the responsibility to do so. That responsibility should, however, be secondary to the supervisory responsibility of the regulators of financial services providers, and should be shared with state entities with authority to enforce consumer protection laws and regulations. As I mentioned at the start, the prudential supervisors can be highly effective in enforcing consumer protection laws, and moreover, responsibility for enforcing consumer protection laws can generate safety and soundness benefits. Regulators who engage in prudential supervision (federal and state), with on-site examinations, should be expected to exercise that authority. Retaining primary supervisory and enforcement authority with the prudential supervisors makes use of existing structures and resources, keeps consumer protection and service to all communities integrated into the prudential regulatory framework, and reduces the possibility of duplicative examinations. At the same time, keeping backup enforcement authority in the CFPA would provide the means for any reluctance of prudential supervisors to engage in effective enforcement to be effectively backstopped.

Congress has a role in making this work better than it has in the past. The likelihood that consumer protection would in fact be integrated into prudential supervision could be enhanced by amending the organic statutes that establish banking and other financial services regulators to (i) make consumer protection an explicit responsibility of regulators on a par with safety and soundness, and make clear that responsibility extends to non-bank subsidiaries and affiliates of banks; (ii) require that at least one member of the governing body of agencies that have governing boards have knowledge and experience concerning consumer finance; (iii) require that each agency have a separate division devoted to consumer protection, with examination staff trained in the field; (iv) set examination cycles for compliance examinations that are similar to the cycles for safety and soundness examinations; and (v) require regular reports to Congress on the topic.

---

<sup>16</sup> Proposal, pages 63-70.

<sup>17</sup> Proposal, pages 59, 65-66.

<sup>18</sup> Proposal, pages 62, 70.

## Funding

A critically important concern in creating any new agency, especially a regulatory agency whose primary constituency is a diffuse public of consumers of financial services, is how to fund it. The two major options, which can be used in tandem (as with the Food and Drug Administration), are appropriations and some sort of special tax or user fee. Appropriations have the advantage of being subject to the normal budget process, in which national priorities are reflected in funding levels. However, as the rather depressing history of funding for both the FTC and the CFTC (as well as for OFHEO, the former regulator of Fannie Mae and Freddie Mac) has demonstrated, consumer safety agencies do not always come out of this process with sufficient funds to meet their responsibilities. User fees also have their problems. Although all agencies that deal repeatedly and primarily with a relatively small group of private firms are subject to regulatory “capture,” in which the interests of the regulated diminish the zeal for regulation, the situation is particularly difficult when the agency is funded by those it regulates.

For the CFPB, a possible solution would be to use appropriated funds to get the agency—including the consumer complaint function—up and running and to fund the research and analytical and other functions that are not purely regulatory. However, long-term reliance on funding the regulatory function through the general budget (even if ultimately funds are appropriated) would fly in the face of the experience with other regulatory agencies. And although regulatory capture is a potential problem with user fees, since all providers of consumer financial services will be subject to the agency’s jurisdiction, the issue of charter choice is not present. This is not to say that a user fee is easy to craft. There is no all-encompassing licensing system to add a fee to,<sup>19</sup> the CFPB’s proposed jurisdiction is so broad that it would be inefficient to tax all transactions covered by it, and requiring federal bank regulators to fund the new agency would put the entire funding burden on only one part of the affected industry. One possibility would be require entities in major groups 60 (depository institutions) and 61 (non-depository credit institutions) of the Standard Industrial Classification to pay a fee, preferably based on transaction volume, not assets, to support the agency. While this would not cover entities that were not “primarily engaged” in providing these services (e.g., a retailer that extends credit), it is likely to reach all major providers, and others could be added as gaps become apparent.

## Relationship between Federal and State Laws and Regulations

A final question that needs to be faced is the relationship between the regulations promulgated by the CFPB and those of other regulators. This is primarily an issue relating to state laws and regulations, and raises the issue whether we are content with a low ceiling (i.e., federal preemption with relatively low standards) or whether we have learned from the recent crisis that a high floor (high federal standards, but with states allowed to supplement) is more effective for both consumers and the economy. Financial institutions are understandably concerned about having to follow multiple sets of rules, especially if they are in conflict. But the Administration’s proposal may actually enhance the likelihood of consistency. If the federal government—either by statute or regulation—sets a relatively high bar with respect to consumer product regulation, states have little interest in adding regulation. On the other hand, there may be local conditions or circumstances in which problems are more apparent or apparent earlier and more appropriate for response at the state level than at the federal, and I believe that door should remain

---

<sup>19</sup> The proposal suggests establishment of a licensing regime for non-depository financial service providers and intermediaries, built on the model for licensing of mortgage originators in the SAFE Act, whose federal responsibilities the Administration proposes to transfer to the CFPB. (Housing and Economic Recovery Act of 2008, Pub. L. 110-289, Division A, Title V, §§ 1501 – 1517, 122 Stat. 2654, 2810 – 2824 (July 30, 2008), codified at 12 U.S.C. 5101- 5116, Proposal at 61.) The federal government would establish minimum standards for licensing providers of consumer financial products who are not already subject to state or federal prudential supervision, and require states to adopt a licensing system with standards at least as stringent as the federal floor. As the proposal suggests, the standards could include net worth and bonding requirements, as well as a central database of providers. Although licensing would not directly enhance consumer protection standards, it could be a way of keeping track of providers, enhancing solvency (including the ability to compensate injured consumers), and potentially establishing a mechanism for collection of fees to support the CFPB.



open. States should not, however, be able to adopt laws or regulations in conflict with federal rules. This is essentially the position that the Administration has taken in its proposal.

The situation can be illustrated with an example. Let us assume the CFPA decides to take up the issue of payroll cards. These are generally a very positive tool by which workers who do not have bank accounts can be paid quickly and safely, even if they are in remote locations. But the cards also can come with a variety of fees that can limit the benefit, especially if workers are not well-informed about how to best use them. Moreover, until recently there was some question whether the funds on the cards benefitted from deposit insurance. So the CFPA might be interested in regulating fees, enhancing disclosure and education, and making certain that the preconditions for deposit insurance are met. Let us say the CFPA adopts regulations that limit the fees that can be charged. A payroll card company notices that dormancy fees—fees that reduce balances when the card is not used—are not explicitly prohibited and decides to implement them. What could a state regulator who believed such fees were improper do?

I think the answer is “it depends,” and that’s an appropriate answer. Did the regulation explicitly state that the fees it covered are the only kinds of fees that could be charged? In that case, the state regulator has an enforcement action—perhaps in concert with the CFPA. Did the regulation explicitly say dormancy fees are allowed? In that case, the state regulator’s concern would be in direct conflict with the federal regulation, and the federal regulation should govern. Is the regulation silent, but it is clear the federal regulators considered limiting dormancy fees and rejected such a limitation? I believe that case also limits the prerogatives of the state regulator. But what if the record is silent, or if the federal regulator explicitly left the issue for another day? In those cases, as well as the situation in which someone invents something that essentially performs the function of a payroll card but is designed to get around the regulatory definition, the state regulator should be free to act. One can hope that he or she (or the state legislature) will act after consulting and potentially in coordination with the CFPA, but limiting the states’ ability to respond to problems that arise outside the scope of federal regulations would, in my opinion, be a mistake.

## **THE PROPOSAL TO MOVE COMMUNITY REINVESTMENT ACT EVALUATIONS TO THE CFPA**

I would like to say a special word about the inclusion of the Community Reinvestment Act in the President’s proposal. The proposal states (at pages 69-70) that “The [CFPA] should enforce fair lending laws and the Community Reinvestment Act . . . [and] . . . have sole authority to evaluate institutions under the CRA.” What is encouraging about this is the Administration’s strong support for CRA and view of CRA as a critical element in making quality financial services available to all people in all communities.<sup>20</sup> As stated in an article I recently co-authored with Jeremy Nowak of The Reinvestment Fund,<sup>21</sup>

[I]t is time for explicit recognition that government regulation and oversight are what enable private financial services companies to operate profitably at high levels of leverage. In return, those companies must be held to an affirmative mandate to fairly and equitably serve all communities, sectors and constituencies. . . . The case for doing so revolves around four observations:

- Mainstream financial institutions have a long history of neglecting lower income and minority communities
- Such neglect degrades the impact of significant government expenditures at the federal, state and local levels
- The dislocation of financial institutions from local communities limits the capacity of these communities to marshal civic resources
- Regulated industries and their regulators are inherently conservative (notwithstanding recent excesses) and overestimate the risks involved in serving these communities”

<sup>20</sup> The proposal does not, however, suggest extending CRA’s obligations beyond banks and thrifts to the other types of financial institutions that would be subject to the jurisdiction of the CFPA.

<sup>21</sup> Nowak, Jeremy and Seidman, Ellen, “Rediscovering a Public Purpose in Financial Services,” Opportunity Finance Network, February 2009, available at [http://www.opportunityfinance.net/store/Downloads/Call\\_to\\_Action\\_021309.pdf](http://www.opportunityfinance.net/store/Downloads/Call_to_Action_021309.pdf).

Nevertheless, I am not convinced that the CFPB is the best place to locate CRA, especially if the CRA obligation is not extended beyond banks and thrifts. This is for three primary reasons. First, CRA explicitly and appropriately states that the affirmative obligation to serve is to be exercised “consistent with safe and sound operation.”<sup>22</sup> This will be harder to accomplish if CRA evaluation is separated from the entity responsible for evaluating safe and sound operation. Second, possibly the most consistently effective part of CRA over the past thirty years has been its support for community economic development—affordable multifamily housing; community facilities such as clinics, schools and community centers; shopping centers and other economic anchors; pre-bankable small business lending; support of Community Development Financial Institutions. These are not consumer protection functions, although there certainly is a correlation between communities in need of economic development and consumers most in need of consumer protection. But they are different concepts, using different tools, for different purposes. Finally, the current enforcement mechanism for CRA—consideration of CRA evaluation at the time of a merger, acquisition or certain other actions—must, as the Administration’s proposal recognizes, remain with the prudential supervisor. This mechanism is outdated in a world in which 4% of banking institutions (those with assets of more than \$10 billion) already hold 77% of the system’s assets.<sup>23</sup> Moreover, it is counterproductive in that the permission to merge that a high CRA rating facilitates also has a tendency to dilute service to the very communities previously well served. Nevertheless, unless and until that mechanism is changed, separating the rating from the enforcement seems unwise.

If the decision is made to move CRA to the CFPB, I suggest three safeguards to mitigate some of the problems cited above. First, there should be a statutory requirement for a separate division of the CFPB devoted explicitly to all parts of CRA, including in particular community economic development and the affirmative obligation to serve all communities. Several of the bank regulatory agencies, including several Federal Reserve Banks, have been doing good work in this area over the last several years, and those staffs could form the basis of such a division. Second, the prudential supervisors should be given an opportunity to participate in CRA examinations and also to review and comment on CRA evaluations before they are issued. Finally, the CFPB should be required to report to the Administration and Congress within a year with recommendations for updating, expanding and improving CRA. Much work has already been done to lay the groundwork for such recommendations;<sup>24</sup> if the CFPB is to effectively implement an affirmative mandate to serve communities, it should bring that work to fruition.

## CONCLUSION

While the current crisis has many causes, the triggering event was almost certainly the collapse of the sub-prime mortgage market. That is an event that need never have happened if both our regulatory system and regulators had been more completely and effectively focused on protecting consumers. For many years, many of us have been pointing out that bad consumer practices are also bad economic practices. Not only because of the damage they do to consumers, but also because when the music stops, we all get hurt. The current state of affairs provides a golden opportunity to make significant improvements in the regulatory system and the Administration has made a bold start. If we do not act now, when will we?

---

<sup>22</sup> 12 USC 1209.

<sup>23</sup> Calculation based on Federal Deposit Insurance Corporation, “Quarterly Banking Profile,” June 2009 (covering first quarter 2009), Table III-A, available at <http://www2.fdic.gov/qbp/2009mar/all3a2.html>.

<sup>24</sup> See in particular “Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act,” Federal Reserve Banks of Boston and San Francisco, February 2009, available at <http://www.frbf.org/publications/community/cra/index.html>.