CHAPTER 19:

How Congress Should Protect Consumers' Finances

Alden F. Abbott and Todd J. Zywicki

Free-market competition is key to the efficient provision of the goods and services that consumers desire. More generally, the free market promotes innovation and overall economic welfare.[1] Imperfect information can, however, limit the ability of competition to be effective in benefiting consumers and the economy. In particular, inaccurate information about the quality and attributes of market offerings may lead consumers to make mistaken purchase decisions—in other words, consumers may not get what they think they bargained for. This will lead to the distrust of market processes, as sellers find it harder to differentiate themselves from their competition. The end result is less-effective competition, less consumer satisfaction, and lower economic welfare.

Fraudulent or deceptive statements regarding product or service attributes, and negative features of products or services that become evident only after sale, are prime examples of inaccurate information that undermines trust in competitive firms. Accordingly, the government has a legitimate role in seeking to curb fraud, deception, and related informational problems.[2] Historically, the federal government's primary consumer protection agency, the U.S. Federal Trade Commission (FTC), has taken the lead in bringing enforcement actions against businesses that distort markets by engaging in "deceptive" or "unfair" practices when marketing their offerings to consumers.[3] In recent decades, the FTC has taken an economics-focused approach in these areas. Specifically, it has limited "deception prosecutions" to cases where consumers acting reasonably were misled and tangibly harmed, and "unfairness prosecutions" to situations involving consumer injury not outweighed by countervailing benefits (a cost-benefit approach).[4] In other words, although the FTC may have erred from time to time in specific cases, its general approach has avoided government overreach and has been conducive to enhancing marketplace efficiency and consumer welfare.

However, Congress has not allowed the FTC to exercise economy-wide oversight over consumer protection, in general, and fraud and deception, in particular. For many years, a hodgepodge of different federal financial service regulators were empowered to regulate the practices of a wide variety of financial industry entities, with the FTC only empowered to oversee consumer financial protection with respect to the narrow category of "non-bank financial institutions." As part of the 2010 Dodd–Frank financial reform legislation, Congress created a new Consumer Financial Protection Bureau (CFPB), loosely tied to the Federal Reserve Board.[5] While Dodd–Frank mandated shared CFPB–FTC consumer protection jurisdiction over non-bank financial institutions, it transferred all other authority over the many separate consumer financial protection laws to the CFPB alone. The CFPB is simultaneously one of the most powerful and least-accountable regulatory bodies in United States history. In marked contrast to the FTC's economics-based approach, the CFPB intervenes in financial market consumer-related practices in a heavy-handed arbitrary fashion that ignores sound economics. The upshot is that far from improving market efficiency, the CFPB *reduces* market efficiency, to the detriment of consumers, producers, and the overall economy. In short, the CFPB's actions are a prime example of government failure.[6]

THE FAILURE OF CFPB CONSUMER PROTECTION

Although supposedly a subunit of the Federal Reserve Board, the CFPB is not accountable to the Fed, and it is technically classified as an Executive Branch agency. Dodd–Frank provides that the President appoints the director of the CFPB for a five-year term, and the director is removable before that only for cause, such as malfeasance or dereliction of duty.[7] The CFPB's budget is provided directly by the Fed, outside the standard appropriations process. Its actions are insulated from judicial review by statutorily mandated *Chevron* deference, which requires courts to defer to the CFPB's interpretation of any "ambiguous" statutory provisions under its jurisdiction, in preference to any competing interpretations by other agencies.[8]

The substantive powers of the CFPB are vast and ill-defined. The CFPB has power to regulate the terms and marketing of every consumer credit product in the economy. And, because many small businesses use personal credit to start and grow their businesses (such as personal credit cards, home equity lines of credit, and even products like auto title loans), the CFPB possesses substantial control over much of the allocation of small-business credit as well. The CFPB has the power to take enforcement and regulatory action against "unfair, deceptive, and abusive" consumer credit terms, an authority that the CFPB has exercised with gusto. Moreover, the CFPB has deliberately eschewed regulatory rule-making that would clarify these terms, preferring to engage in case-by-case enforcement actions that undermine predictability and chill vigorous competition and innovation. Yet despite the broad authority granted to the CFPB, its appetite is broader still: The CFPB has taken action to regulate products such as cellphone billing, for-profit career colleges, and even loans made by auto dealers (despite express jurisdictional limits in Dodd–Frank regarding the latter).

The consequences of this unchecked authority have been disastrous for consumers and the economy. Complicated rules with high compliance costs have choked off access to mortgages, credit cards, and other financial products. Overwhelmed by the costs and uncertainty of regulatory compliance, small banks have exited traditional lines of business, such as home mortgages, and feared entering new lines, such as small-dollar loans. Consistent with the general effects of Dodd–Frank, the CFPB has contributed to the consolidation of the American financial sector, making big banks bigger, and forcing consolidation of small banks. By imposing one-size-fits-all bureaucratic underwriting standards on community banks and credit unions, the CFPB has deprived these actors of their traditional model of relationship lending and intimate knowledge of their customers—their lone competitive advantage over megabanks.

Perhaps the most tragic element of the CFPB train wreck is the missed opportunity for reform that it represents. At the time of Dodd–Frank, the system of consumer financial protection was badly in need of modernization: The existing system was cumbersome, incoherent, and ineffective. Fragmented among multiple federal agencies with authority over different providers of financial services, the federal system lacked the ability to lay down a coherent regulatory regime that would promote competition, consumer choice, and consumer protection consistent with the realities of a 21st-century economy and technology. While there is little evidence that the financial crisis resulted from a breakdown of consumer financial protection (as opposed to safety and soundness issues), reform was timely. But Dodd–Frank squandered a once-in-a-generation opportunity to bring about real reform.

In this chapter, we briefly make the case that some degree of reform of the consumer financial protection system was appropriate, in particular, the consolidation of consumer financial protection in one federal agency. However, we challenge the apparatus constructed by Dodd–Frank that created a new unaccountable super-regulator with a tunnel vision focus on a narrow definition of "consumer protection." Instead, we argue that existing substantive powers were largely sufficient to the task of consumer protection, and that Congress could have achieved better results by acting within the existing institutional framework by simply consolidating authority in the FTC. By working within the existing framework of long-standing substantive authorities and institutional arrangements, Congress could have provided the needed modernization of the federal consumer financial protection system without the unintended consequences that have resulted from the creation of the CFPB.

BEFORE DODD–FRANK

In the period before Dodd–Frank, the consumer financial protection regime was somewhat of a hodgepodge system that failed to provide a coherent consumer financial protection regime that facilitated competition, consumer protection, and choice for consumers. Authority was scattered among different regulatory bodies with authority over different providers of financial services, such as the FTC (mortgage brokers and non-bank lenders), the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the National Credit Union Administration, or the Department of Housing and Urban Development (certain mortgage-lending rules). Efforts at joint rule-making resemble United Nations summit meetings as dozens of regulators circled a table seeking consensus on rulemakings. Moreover, each agency had its own constituency to which it gave particular focus, be it the protection of small banks, or jurisdiction over particular products or services.

The problems resulting from this fragmentation of regulatory authority at the federal level were exacerbated by an unclear division of authority between the state and federal governments. While most depository institutions (such as banks and thrifts) were regulated by the federal government, providers of other services and products (such as mortgage brokers, payday lenders, and pawn shops) were primarily regulated at the state and local level. Other providers of finance-related services, such as debt collectors, were subject to a hybrid system.

Yet many products offered by different types of providers compete with each other.[9] For example, for most payday-loan customers, the closest substitute is bank overdraft protection. Thus, when states eliminate or restrict access to payday loans, the usage of bank overdraft protection and bounced checks typically rises. This suggests that in devising a regulatory policy for access to payday loans, a regulator simultaneously would want to consider policies regarding bank overdraft protection. Similarly, because mortgage brokers compete directly with traditional banks in the provision of mortgages, a coherent consumer protection policy would consider the interrelationships between the two providers so as to construct policies conducive to the promotion of competition and consumer choice.

At the same time, it is important to stress that this case for modernization of the consumer financial protection system is *independent* of the financial crisis. Indeed, many of the areas in which the CFPB has been most active have *nothing* to do with the factors that contributed to the financial crisis, specifically residential mortgages. Services and products, such as payday loans and credit cards, had nothing to do with the financial crisis. It is equally important to note that even the financial crisis itself had little to do with defects in the consumer protection system—the proliferation of low-down-payment mortgages and the decisions of millions of consumers to walk away from underwater mortgages were a matter of misaligned incentives, not consumer protection.[10] The incentives to default created by factors such as the presence of state antideficiency laws on the collection of mortgage defaults, or cumbersome judicial foreclosure processes that substantially slowed the foreclosure process, had little to do with supposed fraud against consumers. Moreover, defaults and foreclosures were much higher in locations with a large percentage of investment and second houses, which suggests that many of the defaults in those areas were driven by investors, not conventional homeowners. Mortgages made with novel terms, such as negative-amortization provisions and so-called teaser rates, did have higher rates of foreclosure, but economists have found little or no support for the hypothesis that the high default rates on those products resulted from fraud against consumers. Yet, the CFPB and the regulatory apparatus created by Dodd–Frank has been premised on the assumption that fraud against consumers was a significant contributor to the foreclosure crisis, thereby mischaracterizing the safety and soundness issues at stake and implementing a set of regulations that would have done little to address the actual problems that brought on the mortgage crisis.[11]

Finally, adding to this litany of examples of government failure is the CFPB's open-ended authority to sanction "abusive" conduct in the financial services industry. The CFPB has yet to engage in a formal rule-making to define the term "abusive," choosing instead to define the term through litigation and settlement, and purposely keeping the reach of the term vague for future cases. This has led to charges of arbitrariness and bias from some actors. The ability of the CFPB to, unexpectedly, attack novel conduct as "abusive," without regard to its merits, predictably will reduce incentives for financial institutions to develop innovative financial instruments and services offerings that could benefit consumers.

The failure of Dodd–Frank and the CFPB to construct a modern and relevant regulatory regime that meets the needs of today's consumers and economy is one of the great tragedies of the post-crisis period. Instead of a modern regime that harnesses modern understanding of consumer behavior and market structure, the CFPB has instead resuscitated a 1970s-style system of command-and-control regulation—one that focuses on banning certain terms and products, and ignores the benefits to consumers of competition, innovation, and choice.[12]

This adverse result for consumers, however, was completely predictable in light of the CFPB's institutional structure, which provides a narrow, tunnel-vision agency focus on a single mission ("consumer protection" as conventionally defined). Particularly noteworthy in that regard are the CFPB's single-director organization (which makes the agency subject to the specific interests and background of its director); and its insulation from oversight by Congress, the President, or the Federal Reserve, which eliminates an opportunity for balanced input and feedback that could help to rein in the CFPB's excesses and the unintended consequences of its actions.[13] Moreover, the CFPB's lack of transparency and accountability makes it particularly susceptible to influence from particular interest groups, such as trial lawyers and consumer activist groups, who can collaborate behind the scenes with the agency in the formulation of policies.

A BETTER PATH

A better path to modernizing and systematizing federal consumer financial protection policy was available at the time of deliberation over Dodd–Frank, and is still available today. Instead of creating an unaccountable super-regulatory agency with a blinkered view of its mission and power concentrated in one person's hands, consumer financial protection would be better achieved by simply consolidating regulatory authority in an existing agency that already has the capacity to act in a fashion conducive to the promotion of sound consumer financial protection policy. Such an agency already exists in the FTC. Consolidating the powers granted to the CFPB in the FTC, which still retains certain regulatory responsibilities with respect to consumer finance,[14] would have a number of advantages over the course chosen in Dodd–Frank.

First, the FTC is a multimember, bipartisan commission.[15] This is an important improvement over the structure of the CFPB, which is neither an independent commission nor an executive agency. Executive agencies are accountable to the President and the electorate through the democratic process. The power of the President to remove a department head is an important constraint on the ability of the agency to pursue its own parochial goals or potential biases. Multimember independent agencies, such as the FTC, offer an alternative form of accountability, namely internal checks and balances brought about through the bipartisan decision-making process. Whereas a single-director structure raises the potential for the director to indulge in biased, erroneous, or parochial decision making, a multimember, bipartisan decision-making process can provide checks on these deviations from sound decision making. Minority-party commissioners can provide a sort of whistle-blowing function to challenge agency actions that they believe to be biased or unjustified. Moreover, the opportunity to publicly dissent can create a record for review in a subsequent court challenge by calling attention to possible flaws in the majority's logic and highlighting particular facts. In addition, the mere opportunity for dissenting commissioners to express their views can increase the legitimacy of potentially controversial agency decisions by providing a partial defense against charges of bias.

Multimember commissions are also useful for providing an array of experiences and backgrounds for members of the commission. For example, over time FTC commissioners have included former state attorneys general's office staff, former congressional staffers and Members of Congress, economists, lawyers, business people, and others. A single-director structure, by contrast, brings an individual with necessarily limited experience. For example, the first CFPB director, Richard Cordray, was a former state attorney general. Thus, while he had experience as a lawyer and law enforcement official, he had little experience as a regulator, and little subject matter expertise in the economics and regulation of consumer credit. A multimember-commission structure enables such an agency to appoint people of complementary skills to positions of leadership.

Multimember commissions also provide greater stability in policymaking over time, with less dramatic swings from one presidential Administration to another. Thus, given the activist and sweeping nature of the initiatives taken under Director Cordray, it is likely that many of these policies will be dramatically reversed by a Republican Administration.

The FTC is also subject to Congress's appropriations process, an important check on the agency's actions. For example, during the 1970s, the FTC engaged in a period of agency overreach and excessiveness very similar to the behavior exhibited by the CFPB since its founding. As a result, however, Congress cracked down on the FTC, reining in its excesses and threatening to close down the agency. Eventually, the FTC corrected course and moved in a more positive direction. In short, although the lack of congressional oversight regarding the CFPB's budget gives the CFPB broad leeway to act, it also deprives the agency of an important feedback mechanism to rationalize its actions and resource allocation choices.

Finally, the FTC has a large Bureau of Economics,[16] staffed with academically trained economists who would be ideally suited to take into account the regulatory economic policy issues, discussed herein, to which the CFPB has paid no heed. This would make it far more likely that agency regulatory decisions affecting consumer credit markets would be taken in light of the effects of agency actions on consumer welfare and the broader economy. This could be done relatively seamlessly and efficiently. The FTC's economic staff already has substantial experience in employing economic tools to assess potential cases of deception and unfairness, which, as previously indicated, are rooted in economic considerations. Moreover, the FTC already has considerable regulatory experience in assessing practices affecting consumer financial services markets, which antedates the CFPB's entry into the field.[17]

CONCLUSION

Long before the 2008 financial crisis, the U.S. consumer financial protection regime was a mess of a system that failed to provide a coherent consumer financial protection regime. Authority was scattered among more than six different regulatory bodies with jurisdiction over different providers of financial services, leading to uncertainty in the marketplace and countless rule-making conflicts among the various regulators. The 2010 Dodd–Frank Act missed an opportunity to correct these problems.

Dodd–Frank did consolidate much of this consumer financial protection authority in one agency, but it gave this power to the CFPB, one of the most powerful and unaccountable regulatory bodies in the history of the U.S. In sum, CFPB regulation of consumer financial services has been an unmitigated disaster. The new framework has harmed consumers and undermined economic efficiency through arbitrary rules. These rules have distorted and, in some cases, destroyed, market opportunities. In particular, poorer Americans, who face limited options for obtaining credit, have been hit especially hard by the CFPB's arbitrary regulatory shotgun approach.

Eliminating the CFPB's authority over consumer protection in financial services, and transferring such authority to the FTC, would greatly improve the current sorry state of affairs. Admittedly, the FTC is a less-than-perfect agency, and even a multimember-commission structure does not prevent institutional mistakes from being made and repeated by the majority. All in all, however, as an accountable institution, the FTC is far superior to the CFPB. Consolidating this authority with the FTC—where it should have been in the first place—will better allow free markets to promote innovation and overall economic welfare. Strengthening this legal framework to provide a single, clearly defined, properly limited set of rules will facilitate competition among financial firms, thus protecting consumers and providing them with better choices.

—**Alden F. Abbott** is Deputy Director of, and John, Barbara, and Victoria Rumpel Senior Legal Fellow in, the Edwin Meese III Center for Legal and Judicial Studies at The Heritage Foundation. **Todd J. Zywicki** is George Mason University Foundation Professor of Law and Executive Director of the Law & Economics Center at George Mason University.

ENDNOTES

1. Companies are rivals for sales and profits under the competition that free markets allow. This rivalry leads to innovation in products and services, productivity improvements through technological change, and the drive to differentiate goods and services from those of rivals. See Robert Hessen, "Capitalism," in David Henderson, ed., *The Fortune Encyclopedia of Economics* (New York: Warner Books, 1993), pp. 110–114.
2. Free markets do, of course, incentivize firms to provide assurances of quality and safety so that consumers will trust their product offerings over those of rival firms. See Daniel Klein, "Consumer Protection," in David Henderson, ed., *The Concise Encyclopedia of Economics* (Indianapolis, IN: Liberty Fund, 2008), pp. 81–83, http://www.econlib.org/library/Enc/ConsumerProtection.html (accessed August 16, 2016).
3. See, generally, Federal Trade Commission, "Bureau of Consumer Protection," https://www.ftc.gov/about-ftc/bureaus-offices/bureau-consumer-protection (accessed November 4, 2016).
4. For a brief discussion of the FTC's approach to unfairness and deception, see Alden Abbott, "The Federal Trade Commission's Role in Online Security: Data Protector or Dictator?" Heritage Foundation *Legal Memorandum* No. 137, September 10, 2014, http://www.heritage.org/research/reports/2014/09/the-federal-trade-commissions-role-in-online-security-data-protector-or-dictator.
5. Dodd–Frank Wall Street Reform and Consumer Protection Act, Titles X and XIV, Public Law 111–203, 124 Stat. 1376, codified in relevant part at 12 U.S. Code § 5301, §§ 5481–5603, and in laws amended (Title X); and 12 U.S. Code § 5481 note, 15 U.S. Code § 1601 note, § 1602 and § 1631 et seq. (Title XIV). For an overview of the key regulatory provisions of Titles X and XIV, see Federal Trade Commission, "Dodd–Frank Wall Street Reform and Consumer Protection Act, Titles X and XIV," https://www.ftc.gov/enforcement/statutes/dodd-frank-wall-street-reform-and-consumer-protection-act-titles-x-and-xiv (accessed November 4, 2016). In creating the CFPB, Congress transferred consumer financial protections from the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Department of Housing and Urban Development. 12 U.S. Code § 5581 (delineating the transfer of consumer financial services functions to the CFPB), and Federal Trade Commission, "Consumer Finance," https://www.ftc.gov/news-events/media-resources/consumer-finance (accessed November 4, 2016) (explaining that the FTC shares authority with the CFPB to enforce the consumer-protection laws with respect to non-bank financial institutions).
6. For a brief assessment of government failure in financial markets (defined as "policy and budget choices by government officials that result in inefficiency"), see Council of Economic Education, "The Role of Government in Financial Markets: Market Failure vs. Government Failure vs. No Failure," http://lei.councilforeconed.org/documents/978-1-56183-572-0-activity-lesson-15.pdf (accessed November 4, 2016).
7. In *PHH Corporation v. Consumer Financial Protection Bureau*, No. 15-1177 (D.C. Cir. Oct. 11, 2016), a three-judge panel of the U.S. Court of Appeals for the District of Columbia held that the CFPB as currently constituted violates the constitutionally mandated separation of powers, and required as a remedy that the "for cause" restriction be stricken from the statute and that the director of the CFPB be made removable at will by the President. One of the three panel judges, however, Karen LeCraft Henderson, dissented from the finding of unconstitutionality, and it is anticipated that the Justice Department will appeal. In short, this holding is tenuous at best. Moreover, even if it is upheld, the holding is of little practical consequence. It "will have no effect in limiting the arbitrary and capricious actions of" the current director. "More generally, as a practical matter, it appears unlikely that any president would closely supervise a highly specialized agency such as the CFPB (let alone seriously consider dismissing its director), given the many high-level responsibilities and political considerations presidents face." Hans von Spakovsky and Alden Abbott, "A Win for Separation of Powers? Court Rules Against Consumer Protection Financial Bureau," *Conservative Review*, October 12, 2016, https://www.conservativereview.com/commentary/2016/10/a-win-for-separation-of-powers#sthash.NXdXRD9T.dpufdirectorhttps://www.conservativereview.com/commentary/2016/10/a-win-for-separation-of-powers#sthash.NXdXRD9T.dpuf (accessed November 14, 2016).
8. Todd J. Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?" *George Washington Law Review*, Vol. 81, No. 3 (April 2013), p. 856, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2130942 (accessed August 16, 2016). Also see Paul Larkin, "The World After Chevron," Heritage Foundation *Legal Memorandum* No. 186, September 8, 2016, http://www.heritage.org/research/reports/2016/09/the-world-after-chevron; Diane Katz, "The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect," Heritage Foundation *Backgrounder* No. 2760, January 22, 2013, http://www.heritage.org/research/reports/2013/01/the-cfpb-in-action-consumer-bureau-harms-those-it-claims-to-protect; and Diane Katz, "Consumer Financial Protection Bureau: Limiting Americans' Credit Choices," Heritage Foundation *Backgrounder* No. 3102, April 28, 2016, http://www.heritage.org/research/reports/2016/04/consumer-financial-protection-bureau-limiting-americans-credit-choices.
9. Robert Clarke and Todd Zywicki, "Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau," *Review of Banking and Financial Law*, Vol. 33, No. 1 (2013), p. 235, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2358202 (accessed August 16, 2016).

10. Todd J. Zywicki and Joseph Adamson, "The Law and Economics of Subprime Lending," *University of Colorado Law Review*, Vol. 80, No. 1 (Winter 2009), pp. 1–86, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106907 (accessed August 16, 2016).
11. Todd J. Zywicki, "Assessing The Effects of Consumer Finance Regulations," testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 5, 2016, http://www.banking.senate.gov/public/_cache/files/58bb96f4-8268-4ecd-95dd-5e35f8d26e4a/060C9C587736B1F08DD0A117FC3EE8B6.zywicki-testimony-4-5-16.pdf (accessed August 16, 2016).
12. Todd J. Zywicki, "The Consumer Financial Protection Bureau and the Return of Paternalistic Command-and-Control Regulation," *Engage*, Vol. 16, No. 2 (July 2015), p. 48, http://mason.gmu.edu/~tzywick2/Zywicki%20CFPB%20Paternalistic%20FINAL.pdf (accessed August 16, 2016).
13. Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?"
14. Federal Trade Commission, "Consumer Finance."
15. See generally, Federal Trade Commission, "Commissioners," https://www.ftc.gov/about-ftc/commissioners (accessed November 3, 2016).
16. Federal Trade Commission, "Bureau of Economics," https://www.ftc.gov/about-ftc/bureaus-offices/bureau-economics (accessed November 4, 2014).
17. Zywicki, "The Consumer Financial Protection Bureau and the Return of Paternalistic Command-and-Control Regulation."