

CAMBRIDGE WINTER CENTER
for Financial Institutions Policy

Losing the Last War

Evaluating “Veto” Powers on Consumer Financial Protection

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EXECUTIVE SUMMARY

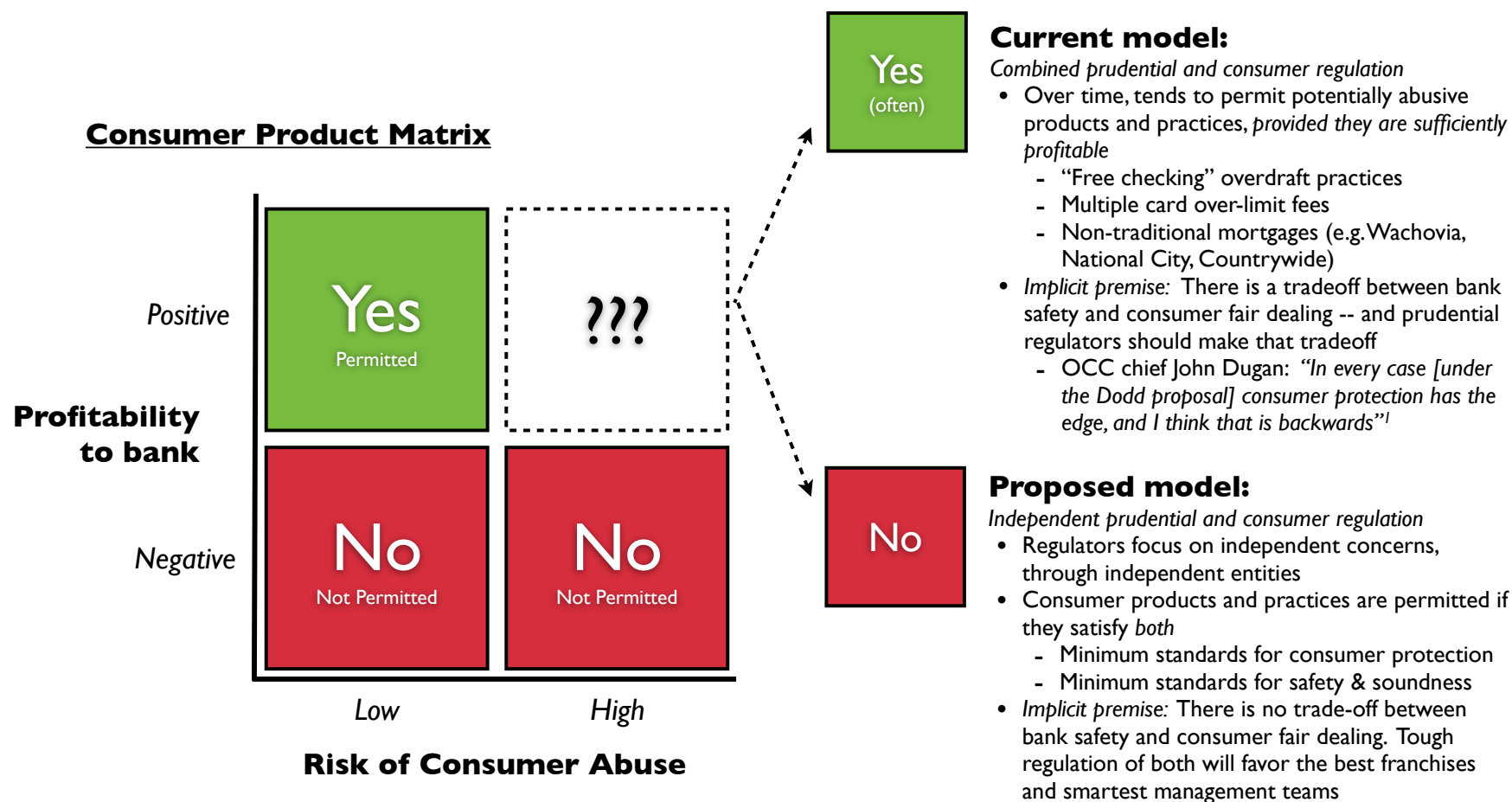
Losing the Last War: Evaluating “Veto” Powers on Consumer Financial Protection

On March 22, the Senate Banking Committee will begin debate over Chairman Dodd’s proposal to reform U.S. financial services regulation. That proposal calls for the creation of a new Bureau of Consumer Financial Protection (“Consumer Bureau”) within the Federal Reserve System. The proposal suffers a significant flaw: The Financial Stability Oversight Council’s ability to overrule judgments of the Consumer Bureau.

- **Mostly independent.** Despite being housed within the Fed, the new Consumer Bureau would benefit from significant functional and financial independence from the Fed or other prudential regulators. This is a substantial improvement. As the OCC itself last week (unintentionally) demonstrated, bank regulators charged primarily with safety and soundness concerns cannot be expected to oversee consumer protection issues well.
- **New “Council” has veto power, for no apparent reason.** Curiously, the Dodd proposal sacrifices a significant measure of Bureau independence by permitting the newly created Financial Stability Oversight Council (the “Council”) to override Consumer Bureau regulations, if the Council finds, by a two-thirds vote of its nine voting members, that those regulations would threaten the safety and soundness of the banking system, or the financial sector’s stability.
 - As a threshold matter, it is not clear what problem this veto provision is meant to solve. There is no empirical evidence that the *over*-protection of consumers ever has created systemic risks.
 - By contrast, there is considerable recent evidence that the *under*-enforcement of consumer protection can contribute to systemic risks.
- **Case example illustrates problem with Council “veto”.** To evaluate the potential impact of the “veto” provision, it is useful to consider what would have occurred during the credit bubble if the Dodd proposal had been in place at that time.
 - Most consumer protection problems do not create systemic risks. But it can happen: as illustrated by the proliferation of non-traditional mortgages (especially prime interest-only and Option-ARMs during 2003-2006), products with considerable non-transparent consumer risk can create massive distortions in the credit markets, and artificially inflate underlying asset values as well.
 - As contemporaneous evidence strongly suggests, at least six of the nine voting members of the Council, if it had existed at the time, would have been likely to vote against the regulation of non-traditional mortgages during the bubble. As a result, Consumer Bureau attempts to better regulate non-traditional mortgages would have been overruled.
- **Veto provision should be re-evaluated.** The veto provision, then, would likely have led to precisely the wrong substantive outcome with respect to the most serious systemic risk created by abusive consumer products and practices during the run-up to the crisis. Policy-makers would do well to re-evaluate that provision in the Dodd proposal.

By creating a Consumer Bureau with substantial independence from prudential bank regulators, the Dodd proposal is a significant step forward from the current regulatory regime. Prudential regulators are principally, and appropriately, concerned with banks' viability and profitability. As a result, over time they have a natural structural incentive to be permissive towards abusive consumer products and practices, so long as those products and practices are reliably profitable for banks. As illustrated by the Comptroller of the Currency's comments last week, prudential regulators often assume (without any obvious empirical backing) that bank safety cannot be achieved without some consumer abuse.

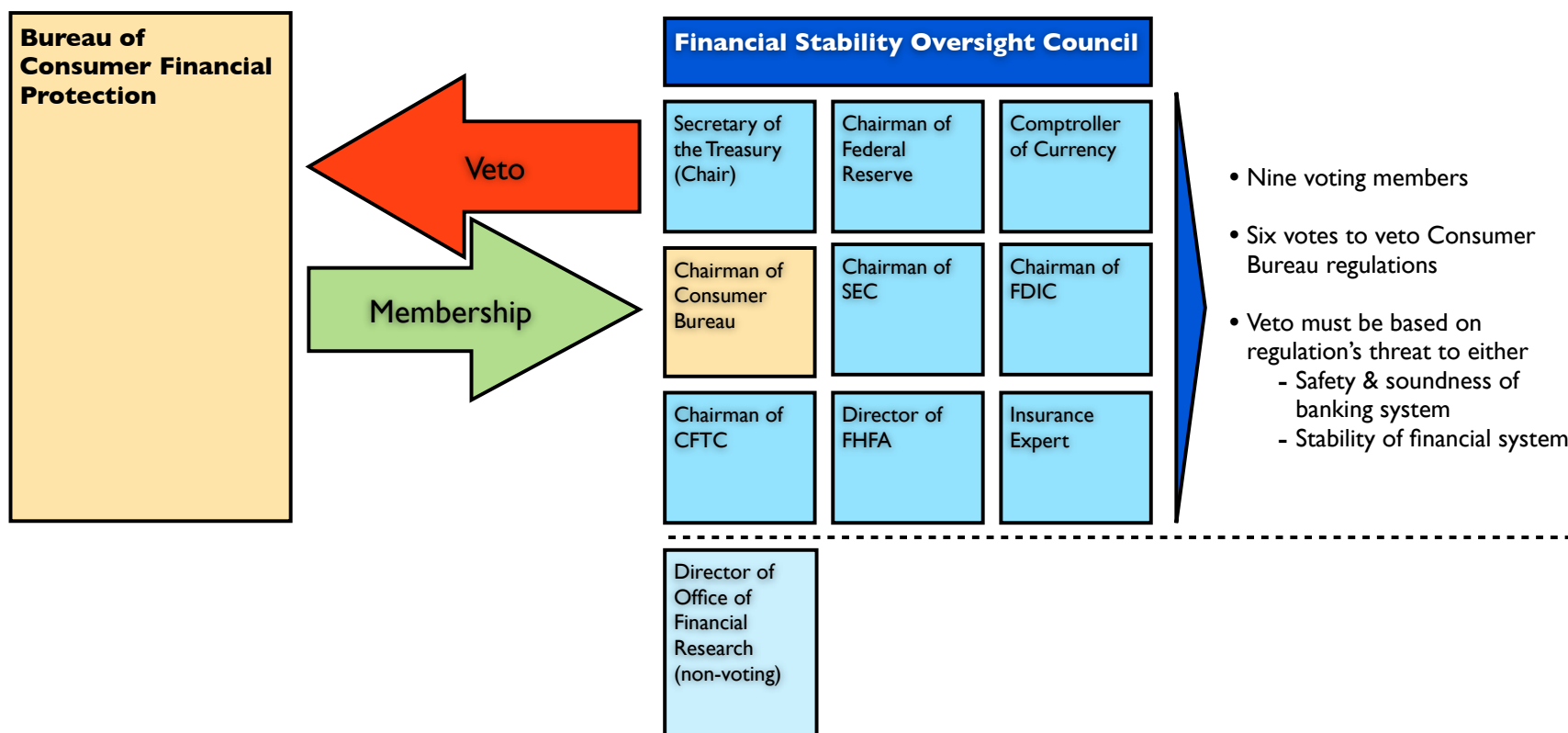
PRUDENTIAL REGULATORS ARE A BAD CHOICE FOR CONSUMER PROTECTION



¹ Suzanne Kapner and Tom Braithwaite, “U.S. Consumer Protection Proposals Attacked”, *Financial Times* (March 18, 2010) (emphasis added).

The Consumer Bureau's Chairman would be one of nine voting members of a new Financial Stability Oversight Council. Presumably, that would enable the Council to have some insight into consumer finance and consumer behavior-driven threats to systemic stability. At the same time, the Dodd proposal contemplates a two-thirds vote of the Council being sufficient to override the Consumer Bureau's consumer protection regulations.

PROPOSED CONSUMER BUREAU HAS A TWO-PART CONNECTION TO THE PROPOSED STABILITY COUNCIL



Source: Chairman Mark of Restoring American Financial Stability Act of 2010 ("Dodd Proposal"), sections 111, 1023 (March 15, 2010).

To evaluate the potential impact of the Council’s veto power over the Consumer Bureau, it is instructive to consider where the veto might have been exercised during the credit bubble, if the Dodd proposal had been in effect at that time. In practical terms, the non-traditional mortgage market was likely the only area that would have both (1) called for Consumer Bureau regulation, and (2) been systemically important enough to enable a Council veto.

REGULATION OF NON-TRADITIONAL MORTGAGES IS THE BEST CASE STUDY FOR “VETO” POWER

	Risk of Consumer Abuse	Risk of Systemic Impact
• Non-traditional mortgages	HIGH	HIGH
• Home equity loans & lines	MED.	HIGH
• Credit card	HIGH	MED.
• Prepaid card	HIGH	LOW
• “Free” checking & overdraft	HIGH	LOW
• Auto finance (dealer channel)	HIGH	MED.
• Auto finance (direct channel)	LOW	LOW
• Student loans	MED.	MED.
• Payday loans	MED.	LOW
• Refund anticipation loans	MED.	LOW

Only non-traditional mortgages would have both clearly called for Consumer Bureau regulation, and have warranted Council review:

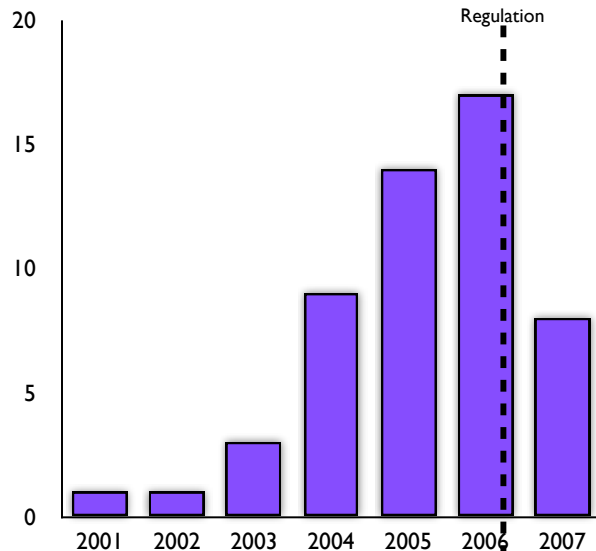
- Obvious red flags on consumer protection
 - Product complexity (teasers, index rates, margins, reduced amortization, neg am caps, recasts, resets, penalties, fees)
 - Mortgage broker intermediation
 - Growth rates out of line with apparent customer utility (seems a bad idea for most people, yet somehow growing explosively)
- Products (and therefore regulation) had major systemic impact
 - Large, growing asset classes
 - Interest-only mortgages
 - Option-ARMs
 - “Layered risk” attributes
 - Reduced documentation
 - No money down (piggy-backs)
 - Clear impact on asset values: reduced early-year monthly payments, enabling “affordability” at higher home prices, thereby fueling bubble

The regulatory failure on non-traditional mortgages was astonishing. Fragmented, competing prudential regulators, facing fierce industry opposition, did not establish final “guidance” on non-traditional mortgages until late 2006, fully three years after the products began their explosive growth. If a Consumer Bureau had been in place during the bubble, its centralized authority and independence from industry fees almost certainly would have enabled faster action.

CONSUMER BUREAU COULD HAVE REACTED FASTER TO NON-TRADITIONAL MORTGAGES

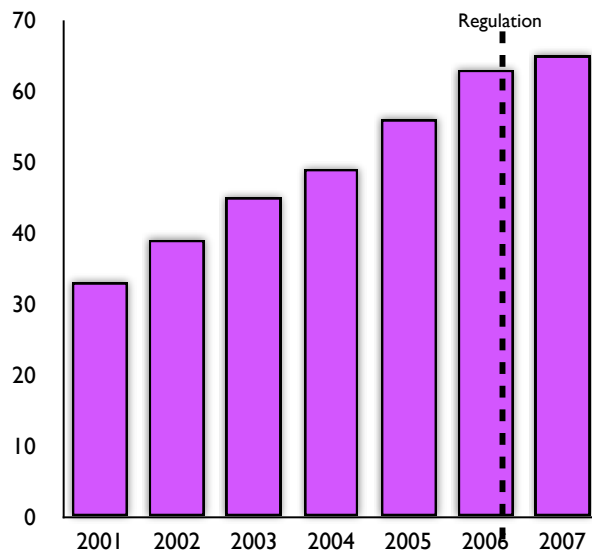
No Money Down

Percent of mortgage originations



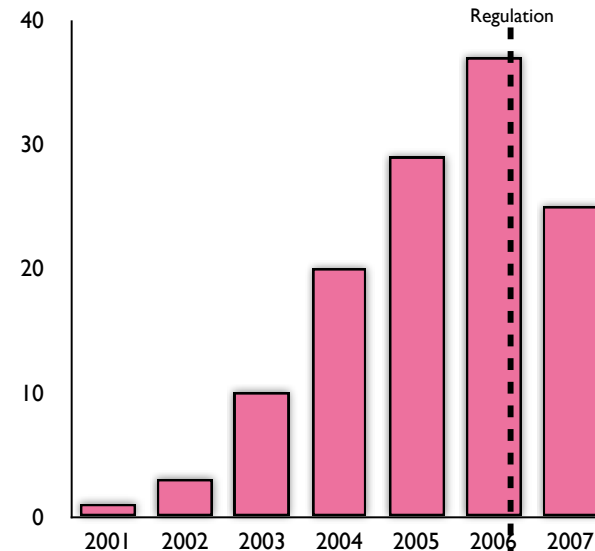
Reduced Documentation

Percent of mortgage originations



Interest Only & Option-ARMs

Percent of mortgage originations



- Prudential regulators did not provide final “guidance” on non-traditional mortgages until September 2006 ... once it was too late to prevent the debt-fueled housing bubble
- Key prudential regulators (OCC and OTS) competed for banks to regulate, and banks themselves opposed timely regulation.
 - “Much of the tenor of the Guidance is that non-traditional mortgage products are inherently riskier than other products. We believe that is incorrect; rather, they simply present different types of risks that may be well-managed by prudent lenders” -- American Bankers Association, March 2006.¹
- The Consumer Bureau, if it had existed at the time, could have moved faster precisely because it is free from the need to compete for, and therefore cater to, industry interests

¹ Paul A. Smith, American Bankers Association Comments on Non-Traditional Mortgage Guidance (March 29, 2006).

Unfortunately, given the public pronouncements of key regulators at the time, it is quite likely that a Financial Stability Oversight Council -- if it had been in place during the credit bubble -- would have overruled a Consumer Bureau's attempts to rein in the non-traditional mortgage market. The existence of the veto provision, in other words, would have prevented the Consumer Bureau from taking its most significant potential actions to forestall the credit crisis.

COUNCIL WOULD HAVE VETOED CONSUMER BUREAU NON-TRADITIONAL MORTGAGE REGULATION

Council Member	Name (2005)	APPROVE	VETO	Rationale
Sec. of the Treasury	John Snow		X	<ul style="list-style-type: none"> Failed to recognize any signs of underwriting deterioration
Fed Chairman	Alan Greenspan		X	<ul style="list-style-type: none"> Fed repeatedly mistook explosion in non-traditional products as "innovation". Despite legislative authority, refused to timely promote mortgage rule-making.
OCC Head	John Dugan		X	<ul style="list-style-type: none"> Both OCC and OTS permitted major regulated firms to pursue originate-to-sell models on non-traditional mortgages, at least in part because it appeared bank profitability and safety were thereby bolstered
Bureau Chairman	N/A	X		<ul style="list-style-type: none"> N/A
SEC Chairman	Christopher Cox		X	<ul style="list-style-type: none"> SEC repeatedly mistook explosion in non-traditional products and markets as "innovation". Most non-traditional mortgages were ultimately securitized, to benefit of largest broker-dealers, which were SEC's largest constituents.
FDIC Chairman	Donald Powell	X		<ul style="list-style-type: none"> Relatively early warnings to industry on bank consumer credit risks associated with non-traditional mortgages
CFTC Chairman	Sharon Brown-Hruska		X	<ul style="list-style-type: none"> No obvious institutional expertise on bank credit issues; would therefore defer to Treasury and Fed leadership
FHFA Chairman	James Lockhart	X		<ul style="list-style-type: none"> Non-traditional mortgages were stealing share from GSEs
Insurance Appointee	N/A		X	<ul style="list-style-type: none"> No obvious institutional expertise on bank consumer credit issues; would therefore defer to Treasury and Fed leadership