

Consumer Protection in Financial Products: Obama Administration Proposes Consumer Financial Protection Agency

Patrick Polcari

*Research Associate, Institute for Consumer Antitrust Studies
Loyola University Chicago School of Law*

In an effort to prevent future financial crises, like the one that has recently crippled the United States economy, the Obama Administration and Congressional legislators introduced a variety of measures that will increase government oversight over financial matters. Much of the new legislation centers on the regulation of Wall Street firms. Examples include limiting executive pay, restraints on derivative trading, and greater transparency requirements for financial firms. However, a main component is the introduction of a new federal agency that would be charged with consumer protection in financial matters, dubbed by some commentators as the Consumer Financial Products Safety Commission. Firms that offer consumer financial products would be required to comply with regulations written by the agency. Additionally, consumer financial protection duties of current agencies would be merged into the new agency. Despite criticism, the formation of such an agency is long overdue and should be enthusiastically welcomed by regulators and financial institutions alike.

Current Consumer Financial Protection

Generally speaking, regulation of any activity can be achieved through two mechanisms: ex ante regulation and ex post judicial involvement. Each regulatory scheme will place more emphasis on either regulating behavior before it occurs or punishing it after it injures depending on the nature of the harm. For example, greater emphasis will be placed on ex ante regulation of nuclear power plants because the cost of a regulatory violation is very high: potential mass destruction. However, emphasis should be shifted from ex ante to ex post judicial intervention where the harm is less severe because the benefits are uncertain and the cost of ex ante regulation can be higher. In such circumstances, it can be beneficial to wait for an injury to develop and then provide a remedy to the affected individuals. In addition, when deciding on the best structure it must be considered whether ex ante or ex post judicial supervision will actually succeed.

In consumer financial products, ex post judicial involvement provides consumers relief from oppressive financial products through two theories: contract law and bankruptcy protection.¹ The primary method allows a plaintiff to seek damages or equitable relief through traditional contract theories, typically unconscionability.² The doctrine of unconscionability allows courts broad discretion to strike down part or all of a contract that “shocks the conscious.”³ Such provisions that are deemed unconscionable

¹ Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. Pa. L. Rev. 1, 70 (2008).

² *Id.* at 71.

³ *Id.*

are the product of unfair bargaining positions, as is often the case with credit card and other consumer financial contracts. Despite this broad discretionary doctrine, courts are often reluctant to use it.⁴ Furthermore, certain aspects of financial contracts, such as interest rates, are preempted by federal law and, therefore, remove much of the court's discretion in consumer financial matters.⁵

Another judicial remedy for consumers is the possibility of seeking bankruptcy protection. By declaring bankruptcy a consumer will be able to avoid a majority of his outstanding debts. This option for consumers provides some incentive to creditors to offer fair credit products.⁶ However, instead of providing safer products to prevent bankruptcy, creditors have lobbied Congress to restrict consumers' access to bankruptcy relief.⁷ Furthermore, although the possibility of bankruptcy exists, many consumers do not view bankruptcy as a viable option: bankruptcy remains on the consumer's credit report for ten years, having obvious adverse effects on his credit rating.⁸ In addition, some individuals feel bankruptcy is immoral or is a sign of irresponsibility and are deterred from seeking such relief.

Contract and bankruptcy law thus provide consumers some remedy to oppressive financial products. In addition, creditors will be deterred from providing unfair products when consumers have these legal remedies available. However, these options are significantly limited and do not provide consumers with complete protection. Therefore, in consumer financial products, ex post judicial intervention is insufficient. In recognition of this, Congress and state legislatures have developed a variety of ex ante regulations.

At the federal level, there is a variety of legislation that has created numerous statutes to regulate consumer financial products. These acts include, but are not limited to, the Truth in Lending Act (TILA)⁹, the Fair Credit Reporting Act¹⁰, the Fair Debt Collection Practices Act¹¹, the Equal Credit Opportunity Act¹², the Home Ownership and Equity Protection Act (HOEPA)¹³. Each of these acts addresses a specific problem that has developed with respect to consumer financial transactions. The narrow way in which each law is tailored limits the discretion and flexibility of the agencies charged with enforcing the law.¹⁴ This is problematic because federal agencies are often created in order to develop expertise and to alter enforcement rules based on changing market conditions. However, the majority of financial consumer protection laws handcuff those

⁴ Christopher L. Peterson, *Predatory Structured Finance*, 28 *Cardozo L. Rev.* 2185 (2007).

⁵ See Bar-Gill & Warren, *Supra* note 1, at 71.

⁶ *Id.* at 72.

⁷ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Pub. L. No. 109-8, 119 Stat. 23 (codified throughout 11 U.S.C.).

⁸ Richard M. Hynes, *Broke but not Bankrupt: Consumer Debt Collection in State Courts*, 60 *Fla. L. Rev.* 1, 25 (2008).

⁹ 15 U.S.C. §§ 1601–1613, 1631–1649, 1661–1667f (2006).

¹⁰ 15 U.S.C. § 1681 (2003).

¹¹ 15 U.S.C. § 1692 (2006).

¹² 15 U.S.C. § 1691 (2006).

¹³ 15 U.S.C. § 1639.

¹⁴ See Bar-Gill & Warren, *Supra* note 1, at 84.

agencies and allow the regulation of only the specific problem identified by Congress, and the time it takes congress to indentify and produce new legislation is often quite lengthy. This is particularly problematic in the financial sector where the financial products market is rapidly changing.

In addition, even where Congress has indentified a problem, the legislation can fall short. An example of this is the Truth In Lending Act. Under the TILA, Congress gave the Federal Reserve Bank the responsibility to write Regulation Z.¹⁵ Regulation Z requires lenders to provide sufficient information so that the consumer can understand the cost of the credit as well as the general nature of the financial product.¹⁶ Enforcement of these provisions, and others like it, are carried out by the Federal Reserve Bank and the other regulatory agencies according to their authority as outlined below. However, an important area where federal regulators lack authority is the mortgage market. Mortgage lenders that are not banks do not fall under these regulations.¹⁷ This creates a regulatory gap that was exploited during the last decade and contributed to the subprime mortgage crisis.¹⁸

The variety of agencies that regulate consumer financial transactions also creates a problem. There are five federal banking agencies that regulate different aspects of the banking industry. The Federal Reserve Bank regulates state-chartered banks that opt into the Federal Reserve System.¹⁹ The Office of the Comptroller of Currency charters and regulates national banks.²⁰ The Office of Thrift Supervision oversees federal savings associations and state-chartered savings associations, which are members of the Deposit Insurance Fund.²¹ The Federal Deposit Insurance Corporation regulates state-chartered banks that are not members of the Federal Reserve System.²² The National Credit Union Administration supervises federal credit unions.²³ Finally, the Federal Reserve Board serves as the overarching supervisor of banks regulated by the other federal agencies.²⁴ Each of these agencies has authority to enforce federal financial consumer protection laws. However, different agencies regulating different entities that offer largely the same products can result in inconsistent and inefficient consumer protection. In addition, a principal reason why these federal regulators do not provide sufficient protection for consumers is that the agencies were created primarily to protect the soundness of the banking system.²⁵ This creates a conflict within the agencies, which on the one hand are

¹⁵ 15 U.S.C 1604 (2006).

¹⁶ 12 C.F.R. pts. 226.1-226.34.

¹⁷ See Bar-Gill & Warren, *Supra* note 1, at 89.

¹⁸ Greg Ip & Damian Paletta, *Regulators Scrutinized in Mortgage Meltdown*, WALL ST. J., Mar. 22, 2007, at A1 (52% of subprime loans were not federally regulated).

¹⁹ See BD. OF GOVERNORS OF THE FED. RESERVE SYS., PURPOSES AND FUNCTIONS (2005), available at http://www.federalreserve.gov/pf/pdf/pf_complete.pdf (last visited Sept. 25, 2009) [hereinafter FED PURPOSE].

²⁰ See About the OCC, available at <http://www.occ.treas.gov/aboutocc.htm> (last visited Sept. 25, 2009).

²¹ See About the OTS, available at <http://www.ots.treas.gov/?p=AboutOTS> (last visited Sept. 25, 2009).

²² See FDIC Mission, Vision, and Values, available at <http://www.fdic.gov/about/mission/index.html> (last visited Sept 24, 2009).

²³ See About NCUA, available at <http://www.ncua.gov/About/Default.aspx> (last visited Sept 25, 2009).

²⁴ See FED PURPOSE, *Supra* note 15.

²⁵ See FED PURPOSE, *Supra* note 15.

charged with protecting consumers but on the other hand need to ensure bank stability and profitability.

Conversely, the Federal Trade Commission (FTC) is charged primarily with protecting consumers.²⁶ Specifically, the FTC has the authority to limit “unfair and deceptive acts and practices.”²⁷ In addition, the FTC is given authority under TILA to regulate consumer financial products provided by non-bank institutions.²⁸ However, the FTC is powerless to regulate banks.²⁹ The FTC’s inability to regulate the banking industry leaves the agency with incomplete authority. Moreover, the Federal Reserve Bank defines “unfair and deceptive acts and practices” in the context of financial products.³⁰ Furthermore, the FTC is charged with regulating all types of consumer transactions, and therefore, the agency has only a limited amount of resources to enforce the consumer financial transactions that it can regulate.

Finally, consumers are often best protected by their state legislatures and state attorneys general. Prior to the 1970s, the banking industry was largely regulated by the individual States. This allowed the States to regulate interest rates to prevent usury. However, following the Supreme Court’s decision in *Marquette National Bank of Minneapolis*, national banks were regulated by state usury laws only where the bank is headquartered, not where the customer is located.³¹ This effectively allowed national banks to locate their headquarters in states with high usury rates and export those rates to out of state customers. By the mid-1990s, this rule no longer applied only to interest rates, but also any payment to a credit granting institution.³² This includes late fees, overdraft fees, and cash-advance fees.³³ Therefore, much of state consumer financial protection laws were effectively wiped out.

The ability of states to regulate financial products in other areas besides interest rates and fees also has been severely curtailed. In 2004, the Office of the Comptroller of Currency released a new regulation insulating banks carrying its charter from state interference.³⁴ Following the release of this regulation, banks, such as JPMorgan Chase and HSBC, switched from state charters to the charter endorsed by the Office of the Comptroller of Currency.³⁵ Here again, once powerful state consumer protection laws have been significantly weakened by federal preemption.

In addition, consumers can find relief through judicial remedies created by state legislators. Every state has consumer laws that allow consumers to bring private suits for

²⁶ Federal Trade Commission Act, 15 U.S.C. §§ 41–58 (2006).

²⁷ *Id.* § 45.

²⁸ 15 U.S.C. § 1607.

²⁹ *Id.*

³⁰ Julie L. Williams & Michael S. 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 (2003).

³¹ See generally *Marquette Nat’l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978).

³² *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996).

³³ *Id.* at 744-45.

³⁴ 12 C.F.R. §§ 7.4007-7.4009 (2008).

³⁵ See Bar-Gill & Warren, *Supra* note 1, at 82-83.

unfair and deceptive practices.³⁶ Much like the contract remedies of unconscionability, this remedy provides consumers with some recourse.³⁷ However, the erosion of state authority over the banking industry limited this remedy as well. Furthermore, the Federal Reserve Board determines the criteria for unfair and deceptive practices in the banking industry, and the Federal Reserve Board's motivation to protect the banking industry weakens this state remedy as well.

The inability of states to protect their citizens coupled with the inefficient federal regulatory structure has left consumers without effective protection. Furthermore, the insufficient judicial mechanisms have left consumers without recourse when harmed by dangerous financial products. This ineffective structure leaves consumers vulnerable and that vulnerability became evident during the financial meltdown and mortgage crisis. The need for a single federal agency to protect consumers in the financial products sector is clear.

Proposed Consumer Financial Protection Agency

In effort to improve protection for consumers in financial products, the Obama Administration has sought to reform regulation in that area. The first measure, the Credit Card Accountability, Responsibility and Disclosure Act (Credit CARD Act), was signed into law on May 22, 2009.³⁸ The Credit CARD Act bans retroactive rate increases, provides stability in credit card contracts for the first year of the contract, and prevents creditors from designing late fee traps.³⁹ This improvement of consumer protection was followed by a stream of additional bills aimed at stabilizing financial regulation. New legislation ranges from reforming credit rating agencies to regulating executive compensation. Most notably, the Obama Administration introduced the Consumer Financial Protection Agency Act of 2009.⁴⁰

The new legislation would create the Consumer Financial Protection Agency, which would be charged with protecting consumers in financial products transactions.⁴¹ The agency is designed "to promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products..."⁴² The legislation will remove consumer protection responsibilities in financial products from other agencies and consolidate that responsibility in the single agency.⁴³ The legislation permits the transfer

³⁶ For a complete list of state unfair trade acts, see Mary Dee Pridgen, CONSUMER PROTECTION AND THE LAW ch. 3, app. 3A (2008).

³⁷ *Id.*

³⁸ See Daniel J. Laudicina, *Congress Joins The Fray, Passes the CARD Act*, 28 No. 8 Banking & Fin. Services Pol'y Rep. 1, 1 (2009).

³⁹ See Fact Sheet: Reforms to Protect American Credit Card Holders, available at http://www.whitehouse.gov/the_press_office/Fact-Sheet-Reforms-to-Protect-American-Credit-Card-Holders (last visited Sept. 25, 2009).

⁴⁰ H.R. Res. 3126, 111th Cong. (2009).

⁴¹ *Id.*

⁴² *Id.* § 1021.

⁴³ *Id.* §§ 1061-1066, 1071-1093.

of personnel from other agencies in order to assure the new agency has the proper resources and experience to protect consumers.⁴⁴ The agency's authority to regulate would be dictated by the nature of the product offered to consumers, rather than the institution offering the product, which prevents against the regulatory gaps that existed in the mortgage market.⁴⁵ The agency is further empowered to create regulations, so that it can keep current with the constant changing financial marketplace.⁴⁶

A major segment of the legislation is the requirement that financial firms offer consumers a "plain vanilla" option.⁴⁷ Such a requirement has been sought by consumer groups for some time. Under this requirement, financial firms will be required to offer consumers a "standard consumer financial product or service" as a substitute to "alternative consumer financial product or service."⁴⁸ The agency will precisely define the meaning of these two terms through regulations once it is created; however, the purpose of the requirement is to give consumers the option of a straightforward and simple product as an alternative to a product that is complex or contains additional fees.⁴⁹ This is deemed as particularly necessary for the average consumer who does not possess a sophisticated financial background.

Another major feature of the legislation is the significant role that the states will play. The legislation permits states to create their own standards to discourage unfair, deceptive, or fraudulent practices.⁵⁰ This reverses the trend of federal erosion of state authority to protect consumers from dangerous financial products. In addition, the legislation mandates that the new agency work together with states and other federal bank regulators to ensure rules are consistent and all the regulators are working together towards a common goal.⁵¹

Opposition and Support for the New Agency

There are two principal groups that oppose the creation of the Consumer Financial Protection Agency: the regulated banks and the current regulators. The "bank" group is a broad group that includes any entity that will be regulated by the new agency. Industry opponents to the agency argue that it will create a fractured regulatory structure for the financial industry, destroy innovation in financial products, and cause confusion by allowing each state to create its own standards.⁵² Current regulators include the federal agencies currently regulating the banks, such as the Federal Reserve Bank. Federal Reserve Bank Chairman Ben Bernanke told the Senate Banking Committee that the Federal Reserve should remain in charge of protecting consumers because of its

⁴⁴ *Id.* § 1064.

⁴⁵ *Id.* § 1002(9).

⁴⁶ *Id.* §§ 1013, 1022.

⁴⁷ *Id.* § 1036.

⁴⁸ *Id.*

⁴⁹ *Id.* §§ 1002(3), 1002(31), 1036.

⁵⁰ *Id.* § 1035.

⁵¹ *Id.*

⁵² Edmund L. Andrews, *Banks Balk at Agency Meant to Aid Consumers*, N.Y. TIMES, June 30, 2009.

“expertise in financial markets, payment systems and supervision positions us well to protect the interests of consumers.”⁵³ The FTC supports the idea of enhancing the current regulatory structure, but it has expressed concern that the new legislation may interfere with the FTC’s consumer protection goals.⁵⁴

Supporters for the new agency include state attorneys general and consumer groups. Consumer groups argue that the recent mortgage crisis provides evidence that if the industry remains unregulated, lenders will continue to drive consumers towards high cost loans. State attorneys general broadly agree as well. Twenty-four of the chief law enforcers in various states signed a letter supporting the new legislation.⁵⁵ They support the new agency because the legislation recognizes the importance of the States to enforce consumer protection laws.⁵⁶

For the most part it is believed that some form of the bill will be passed by Congress.⁵⁷ However, the banking industry is investing millions of dollars in lobbying efforts to prevent its passage.⁵⁸ Despite these efforts, Congressmen, particularly the Democratic Party, remain determined to increase regulation in response to the well publicized breakdown of financial markets.⁵⁹

Looking Ahead

The creation of a new federal agency charged primarily with protecting consumers from dangerous financial products is long overdue. The recent meltdown in the mortgage market demonstrates that the current system failed consumers. A fractured system with several federal agencies presents the possibility of inconsistent supervision over different entities that for the most part are providing the same financial products to consumers. Similarly, many of these agencies have conflicting agendas to ensure the stability of the banking system on the one hand and protect consumers on the other.

In addition, the creation of different regulatory rules in different states is a positive feature of this legislation and should not be advanced as an argument against the bill. One of the key advantages to federalism is that the States can act as laboratories, finding out which laws are more effective than others. Moreover, the States can be expected to be more responsive to their consumers’ needs rather than a federal agency which is fairly insulated from the political process.

⁵³ Paul Wiseman, *Industry lines up to fight consumer protection agency*, USA TODAY, September 14, 2009.

⁵⁴ FTC Testifies on Proposed Consumer Financial Protection Agency, available at <http://www.ftc.gov/opa/2009/07/cfpa.shtm> (last visited 10/5/09).

⁵⁵ Letter from State Attorneys General of 24 States to The Honorable Christopher J. Dodd, Chairman, Committee on Banking, Housing and Urban Affairs, United States Senate, et al. (Aug. 17, 2009) (available at <http://www.scribd.com/doc/18804645/CFPA-SignOn-Letter-81709> (last visited Sept. 25, 2009)).

⁵⁶ *Id.*

⁵⁷ See *Wobbling: Barack Obama’s financial reforms meet political reality*, THE ECONOMIST, July 30, 2009.

⁵⁸ See Michael Kranish and Alan Wirzbicki, *Bailed-out Banks Lobby Hard to Stave Off Limits*, THE BOSTON GLOBE, September 27, 2009.

⁵⁹ *Id.*

There should be little concern that the new legislation will eliminate innovation. Thousands of consumer products are regulated by the Consumer Product Safety Commission and innovation in consumer products continues. This new agency will simply prevent the most dangerous products from harming consumers, while providing consumers the opportunity to opt-in to a simpler product when more complex products are offered. Therefore the proposed legislation ties together a number of loose ends that exist under the current system and should be passed by Congress.

As the agency is created and it begins to adopt regulations, there are important considerations that should be made to ensure the agency is efficient and effective. Credit is vital to the economy; therefore, the agency must be careful which products it labels as too dangerous for the public and which it labels as an “alternative consumer financial product or service.” Additionally, the agency’s greatest contribution may come through efforts to educate the public about the basics of financial products. The proposed legislation specifically authorizes the agency to provide information and guidance to the consumers, specifically to communities that are underserved and likely less educated about financial matters.⁶⁰ The consumer’s responsibility in financial transactions cannot be understated. However, consumers must have the necessary tools to make the right choices before that responsibility can be exercised effectively.

⁶⁰ H.R. Res. 3126 § 1014, 111th Cong. (2009).