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The Regulatory Structure and Consumer Credit Protections

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Introduction

Because of the severity of the current economic recession, the near-collapse of the United State’s financial system in the fall of 2008, and the central role that poorly regulated consumer lending played in sparking both crises, Congress has now enacted the most significant overhaul of the financial regulatory system in eighty years.¹ The new law was the culmination of nearly two years of sharply divided Congressional and public debate about the form and substance these reforms should take. This debate reflected a number of long-standing ideological differences, including the extent of market intervention that is desirable to protect consumers, whether Congress should curb access to consumer credit in any way, and whether the present disclosure-based consumer protection regime should focus more on substantive regulation that prevents deceptive, unfair or unsustainable lending. The debate also reflected new questions regarding what kind of regulatory structure can best achieve desired goals.

To understand the impact and desirability of the structural reforms of consumer credit that were considered and then enacted, this paper begins by reviewing the structure of consumer credit regulation in the U.S that is being supplanted, and the regulatory failures that led to a proliferation of unfair, deceptive and unsustainable lending practices in the mortgage, credit card, overdraft and payday loan markets. Next, the paper argues that while the fractured system of consumer credit regulation was not the central reason for the regulatory failures that occurred, significant structural flaws appear to have exacerbated a strong anti-regulatory bias at banking agencies and encouraged them to overlook or ignore their consumer protection mission. The paper identifies three major structural flaws that were at the root of the failures that occurred: a fractured regulatory regime that did not make consumer protection a priority, the subordination of consumer protection to prudential regulation, and a sector-based system with significant conflicts-of-interest that compromised the independence of some regulators. The paper then examines the strengths and weaknesses of the three major regulatory structures that exist internationally: sector-based, unified and functional (or “twin peaks”) regulation. Finally, it assesses a number of the leading proposals to revamp federal consumer credit regulation that Congress considered, including the structure that was eventually adopted: an independent business conduct agency called the Consumer Financial Protection Bureau. The paper concludes

¹ Public L. 111-203, the Dodd-Frank Wall Street Reform and Consumer Protection Act, was signed by President Obama on July 21, 2010.

that a functional approach that creates separate but coordinated structures for business conduct and prudential regulation has the best chance of protecting consumers in the future.

Structure of Consumer Credit Regulation in the United States Prior to the Establishment of a Consumer Financial Protection Bureau²

In the United States, regulatory responsibility for banking, payment systems and credit is split between the federal and state governments. This system is generally based on the type of financial institution that is being regulated, rather than on the type of product or service that is being offered or the type of regulatory activity that is occurring, such as prudential or business conduct oversight. It is a very complicated, fractured system³ that, as will become apparent, had a great deal of difficulty assessing and preventing serious problems that arose in the lending sector for American consumers.

Federal Regulation

Consumer financial protection regulation regarding payment systems and the provision of credit at the federal level is divided between seven agencies that enforce close to twenty statutes.⁴ Five of these agencies (the “banking agencies”) oversee banks, thrifts and credit unions, with a major focus on the safety and soundness of these institutions. The Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), both independent agencies within the Department of the Treasury, charter and supervise about 1,700 national banks and 750 savings associations (thrifts), respectively.⁵ OTS also supervises state-chartered associations that belong to the Deposit Insurance Fund.⁶ The Federal Reserve System, which consists of the Board of Governors and 12 semi-private regional Federal Reserve Banks, directly supervises approximately 900 state-chartered banks that are part of the Federal Reserve System, provides “umbrella” supervision of banks overseen by other agencies, and supervises all bank holding companies.⁷ The Federal Reserve also lends money to troubled banks, establishes

² This section describes the federal consumer credit regulatory structure as it exists until the Consumer Financial Protection Bureau is operational. Under the law, this will likely occur between six and twelve months after the law took effect on July 21, 2010. §1062, H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act.

³ Pan (2009, p. 36-37). “...the United States has the dubious distinction of having one of the most complex and arguably least coordinated regulatory structures in the world.”

⁴ Warren (2009, p. 2); Keest (2009, p. 8, Appendix B).

⁵ Government Accountability Office (2009, p. 8, 11).

⁶ Office of Thrift Supervision (2007a, p. 2).

⁷ Federal Reserve Board (2009e, p. 65). Following the Gramm-Leach-Bliley Act in 1999, bank holding companies regulated by the Federal Reserve may also now own securities broker-dealers or insurance companies, both of which are activities regulated either

national monetary policy and provides a range of financial services to banks, the U.S. government and foreign institutions, including helping to operate the nation's payment system.⁸ The Federal Deposit Insurance Corporation (FDIC) regulates approximately 5,200 state-chartered banks that do not join the Federal Reserve System but use federal deposit insurance.⁹ It also is the back-up supervisor for all institutions it insures, in order to prevent possible deposit insurance losses.¹⁰ The National Credit Union Administration (NCUA), which is an independent agency, charters and supervises over 5,000 federal credit unions and operates a fund that insures savings accounts in federal credit unions and about 3,000 state-chartered credit unions.¹¹

To coordinate and harmonize policy among all regulators of depository institutions, including those at the state level, the Federal Financial Institutions Examination Council (FFIEC) was established in 1979 by Congress. The FFIEC includes the five federal banking regulators and a committee of state banking and credit administrators.¹²

The other major player in federal credit regulation is the Federal Trade Commission (FTC), which has authority to pursue consumer regulation of non-banks. The agency is prohibited under the FTC Act from supervising banks or using its authority to pursue unfair and deceptive acts and practices in use by banks.¹³ Section 5 of the FTC Act grants this authority to the banking regulators.¹⁴ The FTC can oversee many non-bank entities and financial services providers, such as credit reporting agencies, auto lenders, and retail credit card issuers.¹⁵ Due to a finite budget, a broad mandate to regulate hundreds of products and services and other priorities, the FTC has taken little leadership in protecting consumers from unfair and deceptive lending practices in the lending markets.¹⁶ It has, however, taken initiative in investigating and overseeing non-credit products, services and problems under its mandate related to the provision of credit, including debt management abuses, mortgage foreclosure scams and identity theft.¹⁷

by the Securities and Exchange Commission or a state insurance authority. "Umbrella" supervision refers to the role of the Federal Reserve as regulator of the entire entity, not solely the bank holding company.

⁸ Government Accountability Office (2009, p. 8-9).

⁹ Federal Deposit Insurance Corporation (2008a, p. 13); Government Accountability Office (2009, p. 9).

¹⁰ Id.

¹¹ National Credit Union Administration (2007); Government Accountability Office (2009, p. 11).

¹² Federal Financial Institutions Examination Council (2009).

¹³ 15 U.S.C. §45(a) (2) (2006).

¹⁴ 15 U.S.C. §57a(f) (2006).

¹⁵ Federal Trade Commission (2008).

¹⁶ Rheingold (2009). "...As a 'generalist' agency charged with 'consumer protection' over the entire market, the FTC has limited resources to carefully examine all the predatory and abusive practices that happen on a daily basis. Despite this obviously difficult task, the terrible problems that existed in the credit marketplace were obvious to many, and if the FTC had the 'will' to actually engage in real oversight, much could have been done to protect the American public from the current credit crisis."

¹⁷ Plunkett (2009c).

All of these agencies are empowered to act under a number of narrow consumer protection laws, most of which focus primarily on providing information to borrowers about credit transactions, rather than regulating lending products or practices.¹⁸ These statutes include the Truth in Lending Act (TILA)¹⁹, the Real Estate Settlement Procedures Act (RESPA)²⁰, and the Home Ownership and Equity Protection Act (HOEPA).²¹ Mortgage lending is also regulated under the Fair Housing Act (FHA), the Equal Credit Opportunity Act (ECOA), and the Community Reinvestment Act (CRA). Rule-writing authority for these statutes is generally vested with the Federal Reserve, OTS and NCUA, not with the FDIC or OCC.²²

TILA and RESPA require uniform disclosures regarding the cost of mortgage and credit card loans and settlement costs, respectively. HOEPA, by contrast, vests the agencies with substantive authority to prevent high cost or unfair and deceptive mortgage loans. The FHA and the CRA are both aimed at addressing historic lending problems in minority and low-income communities. The FHA contains civil rights protections that prohibit lending discrimination.²³ The CRA attempts to address redlining concerns and establishes a “duty to serve” by regulated lenders regarding the credit needs of their entire communities.

State Regulation

Consumer financial protection at the state level involves regulation of state chartered banks and credit unions and state-based non-bank lenders, as well as enforcement of state consumer protections laws, including state laws prohibiting unfair and deceptive acts and practices. Roughly 70 percent of all banks, or 6,000 institutions, have state charters, which represents approximately 30 percent of banking assets.²⁴ The Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal Act), adopted in 1994, stated that while banks could establish interstate branches, these branches would be subject to state laws with respect to intra-state branching, community reinvestment, fair lending and consumer protection in their host state.²⁵ States also supervise over 88,000 mortgage company licenses, over 68,000 branch licenses, and approximately 357,000 loan

¹⁸ Levitin (2009b, p. 1-2). Describing centerpiece of current regulatory scheme as “disclosure-based.”

¹⁹ 15 U.S.C. §§ 1601-1993r.

²⁰ 12. U.S.C. §§2601-2617. A seventh federal agency, the Department of Housing and Urban Development, writes rules under RESPA and is the primary enforcement agency. See <http://www.hud.gov/offices/ogc/aboutogc.cfm>.

²¹ 15. U.S.C. §§1601, 1602(aa), 1639(a)-(b).

²² Bair (2007, p. 10); Dugan (2009, p.7).

²³ Fair Housing Act, 15 U.S.C. §3605 *et seq.* (1968).

²⁴ Raskin (2009, p. 2-3).

²⁵ *Id.*

officer licenses.²⁶ Non-bank lending institutions fall under the sole purview of the states, although these institutions, such as debt collectors, check cashers, loan brokers, and credit reporting agencies are typically not regulated by banking commissioners.²⁷

States laws are not uniform and have varying degrees of consumer protection, although some states are known as innovators in consumer protection, addressing areas such as predatory mortgage lending and fiduciary duties.²⁸ Furthermore, many states have issued stricter regulation of mortgage lending, data security and credit card disclosures than federal regulators.²⁹ However, states struggle to maintain strict enforcement because of federal efforts to preempt the application of state banking and fair lending laws to nationally chartered institutions.³⁰

Most states have consumer affairs or protection offices within the executive branch that investigate unfair and deceptive acts and practices, although attorney generals are most often responsible for enforcement of consumer protection laws.³¹ Unfair and deceptive acts and practices (UDAP) were first prohibited by the FTC in 1938, under the Federal Trade Commission Act, and at least one statute has been adopted by all fifty states and the District of Columbia.³² These state statutes form the basis for state and private enforcement of UDAP, which is needed since much of federal law does not allow for individual consumer redress of fraud in cases such as predatory mortgage lending and payday lending.³³ Although many state statutes protect consumers from predatory lending, five states immunize almost all lenders and creditors from UDAP, and many other states allow exceptions for businesses such as debt collectors and payday lenders.³⁴ Although all states except Rhode Island allow consumers to seek civil penalties, enforcement of UDAP statutes varies across states due to differing civil penalty limits, budget and size of the attorney general's office, and requirements of proof of intent or knowledge in civil cases.³⁵

Recent Consumer Credit Regulatory Failures

²⁶Smith (2009, p. 5).

²⁷Bair (2007, p. 7); Maine Office of Consumer Credit (2009).

²⁸Bair (2007, p. 8).

²⁹Antonakes (2007, p. 6).

³⁰Id (p. 3, 6).

³¹Meier, et al. (1998, p. 403-404).

³²Carter (2009, p. 5).

³³Carter (2009, p. 6).

³⁴Cater (2009, p. 14).

³⁵Id. (p. 17-19).

An examination of the role of federal regulatory agencies in overseeing the consumer credit markets in four segments of the credit market – mortgage, credit card, overdraft and payday lending – reveals that there was a consistent pattern of serious regulatory failures. First, regulators seemed to overlook or ignore widespread evidence of unfair, deceptive and unsustainable lending over a long period of time. If they did identify problems in each of these markets, they often expressed prudential rather than consumer protection concerns. Moreover, some regulators used safety and soundness concerns to oppose proposed consumer protection measures. When agencies acted to limit some practices, they commonly issued non-binding guidance, rather than enforceable rules, which lenders frequently ignored. Finally, agencies did not begin to use their authority to limit unfair and deceptive acts and practices in most cases until Congress began to move competing legislation or, in the case of the Federal Reserve, threatened to take away its rule-making authority.

Mortgage Lending

A significant cause of the most severe economic crisis since the Great Depression was the failure of regulators to stop abusive and unsustainable subprime mortgage lending.³⁶ Subprime loans and the recession helped trigger more than 4.2 million prime and nonprime foreclosures before 2010,³⁷ the highest ever seen in the modern mortgage market.³⁸ Goldman Sachs estimates that prime and nonprime foreclosures will increase to 13 million by the end of 2014.³⁹ Subprime losses and the recession also triggered a cascading series of events in the housing and securities markets that, among other developments, have led to trillions of dollars in losses to homeowners not facing foreclosure,⁴⁰ dramatic reductions in retirement investments for millions of Americans⁴¹ and significant losses in tax revenue for state and local governments.⁴²

When assessing the potential effectiveness of the new regulatory architecture, it is useful to evaluate which firms were responsible for the growth of the nonprime mortgage markets (which include subprime, Alt-A and option arm loans) that have caused so much economic “carnage,”⁴³ as well as which regulators could have prevented the growth of these markets and why they failed to

³⁶ Stiglitz (2008, pg. 1); Government Accountability Office (2009, p. 1).

³⁷ Colpitts (2009).

³⁸ Center for Responsible Lending (2009b, p. 1).

³⁹ Hitzius and Marschoun (2009, pg. 16).

⁴⁰ Center for Responsible Lending (2009b, p. 2).

⁴¹ Mackenzie (2008, p. 6).

⁴² Dadayan and Boyd (2010, p. 1).

⁴³ Gramlich (2007, p. 3,4).

act. It is also important to ask why there was not adequate, or in some cases, any oversight of the capital markets that fueled the substantial growth of unsound lending. Much public policy analysis has been devoted to this second question, which is not a focus of this paper.

An evaluation of the regulatory failures that occurred must begin with the federal banking agencies, particularly the Federal Reserve, the OCC and the OTS, which failed to use significant statutory rule-writing, supervisory and enforcement authority to stem the subprime crisis. For example, Congress has repeatedly granted federal banking agencies the authority to establish and enforce standards against unfair and deceptive practices over a 50 year period. The Federal Trade Commission Act forbade commercial activities that were unfair or deceptive in the 1930s.⁴⁴ In 1966, Congress authorized banking agencies to bring enforcement actions for unlawful actions, including unfair and deceptive practices and then, in 1975, required banking agencies to set up consumer affairs divisions and to take action regarding consumer complaints involving deceptive acts.⁴⁵ Also in 1975, Congress provided the Federal Reserve, the Federal Home Loan Bank Board (this authority was later shifted to the OTS) and NCUA with explicit rule-making authority under Section 5 of the FTC Act to prevent these practices.⁴⁶ Thus, even before Congress gave the same three agencies rule-making authority to take action in the nascent subprime mortgage market (see below), it had already granted them significant authority to pursue abusive acts in that market.

Federal Reserve Board Regulation

With the enactment of HOEPA in 1994, the Federal Reserve gained regulatory authority over all mortgage lenders, including state-based, non-depository lenders.⁴⁷ A key provision of HOEPA is designed to eliminate home “equity stripping” by forbidding the sale of some high-cost refinance loans. The provision was drawn so narrowly as to cover only a small part of the emerging subprime market. It also does not apply to home purchase, home equity or reverse mortgage loans.⁴⁸ Lenders easily evaded it by pricing their loans just below the high-cost loan threshold in the law and expanding into the sale of home purchase loans.⁴⁹ The Federal Reserve took modest steps in 2001 to improve rules under the law by banning some practices, such as

⁴⁴ Federal Trade Commission Act, 15 U.S.C. 45(a)(1)

⁴⁵ 15 U.S.C. Sec. 57a.

⁴⁶ 15 U.S.C. Sec. 57a(f)

⁴⁷ 5 U.S.C. §§ 1601, 1602(aa), 1639(a)-(b).

⁴⁸ 15 U.S.C. §§1602 (aa)(1)-(4); 12 C.F.R. §226.32(a)(1), (b)(1).

⁴⁹ McCoy et al. (2009, pg. 1334).

engaging in a pattern or practice of refinancing certain high cost loans when it is not in the borrower's interest.⁵⁰

HOEPA also provided the Federal Reserve Board with potentially more significant authority to regulate unfair, deceptive, or abusive lending practices of both purchase and refinance loans, regardless of the interest rates or fees charged.⁵¹ This provision granted regulators broad authority to prevent many of the lending abuses that led to the current crisis.⁵² Former Federal Reserve Chairman Alan Greenspan explained later that he did not use this authority because he did not want to limit financial innovation, he thought making determinations about deceptive and unfair behavior was arbitrary and ineffectual, and he believed market forces would cause lenders to effectively regulate their own behavior.⁵³ It was not until July of 2008, under new Chairman Ben Bernanke, that the Federal Reserve issued rules under this provision regulating unfair and deceptive practices involving some, but not all, loans in the subprime mortgage market.⁵⁴ For example, the rule largely allowed controversial practices like yield spread premiums (YSPs) and prepayment penalties to continue.

In addition, the Federal Reserve has supervisory authority over non-bank mortgage lenders owned by bank holding companies but not owned directly or indirectly by banks or thrifts. This included some of the largest and most reckless subprime and Alt-A lenders of the era, including HSBC Finance, Countrywide Financial Corporation and Wells Fargo Financial. The Federal Reserve took only one public enforcement action for poor underwriting by these firms between 2003 and 2007.⁵⁵ In fact, the Federal Reserve Board of Governors made a formal decision not to supervise non-bank affiliates under its purview or to investigate consumer complaints regarding non-bank subsidiaries.⁵⁶ In 2007, it ended this policy by starting a pilot project with the OTS and two state supervisory associations to supervise non-bank affiliates, which it made permanent last year.⁵⁷

The Federal Reserve also regulates bank holding companies and, under the Gramm-Leach Bliley Act,⁵⁸ Congress charged them with regulating new financial holding companies with significant higher concentrated risk, such as from poorly underwritten subprime loans by

⁵⁰ Braunstein (2007, p. 9).

⁵¹ 15 U.S.C. § 1639(l)(2).

⁵² McCoy et al. (2009, pg. 1334).

⁵³ Greenspan (2005); Committee on Oversight and Government Reform (2008, p. 89-90, 148). Braunstein (2007, p. 10).

⁵⁴ McCoy et al. (2009, p. 1334-35); U.S. National Archives and Records Administration (2008, 44522).

⁵⁵ McCoy et al. (2009, p. 1345).

⁵⁶ Gramlich (2007, p. 8-9); Appelbaum (2009a).

⁵⁷ Braunstein (2009).

⁵⁸ Pub. L. No. 106-102 § 111, 12, U.S.C. § 1844(c)(2)(C).

non-bank subsidiaries that were created by the act.⁵⁹ However, Congress substantially limited the Federal Reserve’s authority to effectively supervise this kind of systemic risk by placing several restrictions on its supervisory authority.⁶⁰

Leaders of the Federal Reserve have responded to concerns about its willingness to use its statutory consumer protection authority by admitting that “a fundamental lesson of the financial crisis is that we need to do a better job for consumers of financial products.”⁶¹ They have also stated that the Federal Reserve has improved its track record on consumer protection considerably since 2007 by, among other initiatives, implementing the non-bank supervision program cited above and issuing rules on nontraditional mortgages as mentioned above. They have pointed to the Federal Reserve’s final rule on unfair and deceptive credit card practices and a proposed rule regarding closed-end mortgages and home equity lines of credit, including compensation arrangements for mortgage originators, as strong consumer initiatives.⁶²

⁵⁹ McCoy et al. (2009, p. 1345).

⁶⁰ Id., (p. 1346).

⁶¹ Duke (2009, p. 1).

⁶² Duke (2009, p. 2-3).

Office of the Comptroller of the Currency and Office of Thrift Supervision Regulation

The record of the two federal regulators that supervised nationally chartered institutions – the OCC and the OTS – must be examined in the context of how much questionable lending occurred at the national banks under their purview and how effectively they used their supervision and enforcement powers to prevent this lending. It is also important to examine whether risky nontraditional mortgage lending contributed to the failure or near-failure of regulated depository institutions.

Both agencies widely trumpeted their “light touch” prudential and consumer protection regulatory approach and moved aggressively to attract institutions to their charters and block enforcement of many state laws against national institutions.⁶³ Although state-based non-bank lenders were the largest providers of subprime loans,⁶⁴ national banks overseen by the OCC were major players in offering poorly underwritten Alt-A loans, no documentation and low documentation loans, and even subprime loans. (Alt-A loans are nonprime mortgages that are given with little or no documentation to borrowers who do not have the tarnished credit of subprime borrowers.)⁶⁵ Moreover, when the largest “too big to fail” national banks got involved in risky mortgage lending, they created systemic risk that non-bank lenders did not. By 2006, the OCC had allowed all of the five largest national banks in 2005 to become significantly involved in the nontraditional mortgage markets. Bank of America and JPMorgan Chase Bank issued substantial volumes of stated-income and no-documentation loans. Citibank was allowed to purchase the subprime lender Argent Mortgage. Alt-A loans issued by Wachovia Bank and Option ARM loans offered by firms owned by Wachovia Corporation were a major source of loan losses. As these loans soured, Wachovia’s ratio of net write-offs on home loans to all outstanding loans ballooned 2,400%, triggering its forced sale to Wells Fargo. The firm that bought Wachovia, Wells Fargo Bank, sold large quantities of subprime and reduced documentation loans and suffered large losses.⁶⁶ In 2008, the Treasury Department’s Inspector General issued a report critical of the OCC’s supervision of risky loans.⁶⁷

Comptroller of the Currency John Dugan has repeatedly expressed a preference for supervision and non-binding “guidance,” rather than public enforcement and rule-making, to

⁶³ Bravin and Beckett (2002); Appelbaum and Nakashima (2008).

⁶⁴ Government Accountability Office (2009, p. 24).

⁶⁵ Wilmarth (2009, p. 1015-16).

⁶⁶ McCoy (2009, p. 13).

⁶⁷ Department of the Treasury (2008b).

achieve the agency's regulatory goals. "When it comes to consumer compliance, banking regulators do not have an 'enforcement-only' regime; instead, our regime is better described as 'supervision first, enforcement if necessary.' And supervision is such a powerful and effective tool that enforcement, especially in the form of formal enforcement actions, proves to be much less necessary than it is in 'enforcement only' regime."⁶⁸ In the build-up to the subprime crisis, the OCC promulgated only a single rule on consumer protection, prohibiting mortgages that borrowers could not afford.⁶⁹ However, the rule was ambiguous and loosely enforced.⁷⁰ During the twelve years between 1995 and 2007, the OCC issued only thirteen public enforcement actions against the 1,600 national banks it regulates, and none against the eight largest under its purview.⁷¹ At the same time, the OCC increasingly preempted state laws designed to quell the growing mortgage crisis,⁷² culminating in its 2004 rules preempting both state laws and state enforcement of laws over national banks and their subsidiaries.⁷³

The OTS was the first agency that adopted federal preemption,⁷⁴ and like the OCC, made little effort to rein in nontraditional mortgage lending by the firms it regulated. In fact, it permitted the largest federal savings and loans to aggressively offer the full range of subprime, Alt-A and Option ARM loans. As a result, OTS regulated institutions were at the center of subprime-related failures, brought down by significant concentrations of badly underwritten loans. Five of the seven biggest failures in 2007 and 2008 were OTS-regulated. By the end of 2008, thrifts totaling \$355 billion in assets failed.⁷⁵ In 2008 alone, the government seized three of the largest OTS-regulated institutions.⁷⁶ Three other institutions were forced into sales and mergers to prevent similar seizures.⁷⁷ Like the OCC, the OTS favored the use of non-binding guidance to direct the institutions it regulates, which appears to have been ignored in several cases.⁷⁸

Relative Responsibility of Federal or State Regulators for Subprime Failures

In response to criticism that they could have prevented many problems in the subprime market, national regulators and regulated banks have consistently countered that subprime

⁶⁸ Dugan (2007, p. 11).

⁶⁹ U.S. National Archives and Records Administration (2004, p. 1904, 1911).

⁷⁰ McCoy (2009, p. 13).

⁷¹ Wilmarth (2007, p. 14).

⁷² Plunkett (2009b).

⁷³ Wilmarth (2007, p. 8-9, 10-11).

⁷⁴ McCoy et. al. (2009, p. 1348).

⁷⁵ McCoy (2009, p. 11).

⁷⁶ Appelbaum and Nakashima (2008).

⁷⁷ Id.

⁷⁸ McCoy (2009, p. 12).

lending was dominated by state-regulated non-bank lenders. In testimony in 2008, Comptroller Dugan stated that, “national banks and their subsidiaries originated only about 10 percent of all subprime mortgages in 2006 (when underwriting standards were weakest).”⁷⁹ In a footnote, Mr. Dugan conceded that while national banks were not the “dominant originators...some continue to serve this segment of borrowers... [and] it is likely that national banks’ share of the subprime mortgage originations is increasing.”⁸⁰

Academics and consumer organizations have released information that demonstrates that national lenders and their subsidiaries were, in fact, major players in all the nontraditional mortgage markets, especially toward the end of the housing boom. Depository institutions originated 54 percent of all nonprime mortgages in 2006 and 79 percent in 2007.⁸¹ In the peak year for nontraditional loans of 2006, mortgage lending by national banks, federal thrifts and their operating subsidiaries made up almost one-third of all subprime loans, forty percent of all Alt-A loans, and just over half of Payment Option and Option ARM loans.⁸² Additionally, information compiled by law professor Patricia McCoy shows that among depository institutions, federal thrifts had the worst default rate for one-to-four family residential mortgages from 2006 through 2008, followed by national banks. Both state banks and thrifts had lower default rates than their national counterparts.⁸³

Many states did fail to properly regulate mortgage brokers and non-bank lenders operating in the subprime lending market.⁸⁴ However, many states also acted long before federal regulators to address lending abuses. The first state anti-predatory lending statute was enacted in North Carolina in 1999. By the end of 2005, a majority of states had put comparable laws on the books and were blocked by the OTS and OCC from enforcing them against national institutions or their subsidiaries.⁸⁵ A 2009 study found that states with strong anti-predatory lending laws had lower delinquency and foreclosure rates than states without such laws. It also found that national banks increased subprime lending significantly following the issuance of OCC preemption rules in 2004.⁸⁶ States had also initiated a number of enforcement actions against

⁷⁹ Dugan (2008, p. 11).

⁸⁰ Id.

⁸¹ Wilmarth (2009, p. 1016).

⁸² Saunders (2009a, p. 11-13).

⁸³ McCoy (2009, p. 15).

⁸⁴ Dugan (2009, p. 8-9)

⁸⁵ McCoy et. al. (2009, p. 1357).

⁸⁶ Center for Responsible Lending (2009a).

national banks and their affiliates.⁸⁷ These preemptive measures provided further discouragement to the remaining states to enact laws, as they would apply a higher standard than existed at the federal level, given the Federal Reserve’s unwillingness to use its HOEPA authority to stop unfair and deceptive practices at both state and federally regulated institutions.

Fair Lending Problems

Several studies have documented pervasive racial discrimination in the distribution of subprime loans. One such study found that borrowers of color were more than 30 percent more likely to receive a higher-rate loan than white borrowers, even after accounting for differences in creditworthiness.⁸⁸ Another study found that *high-income* African-Americans in predominantly black neighborhoods were three times more likely to receive a subprime purchase loan than *low-income* white borrowers.⁸⁹

African Americans and Latinos were more likely to receive Payment Option mortgages, while African Americans were more likely than non-African Americans to receive interest-only loans.⁹⁰ African-Americans and Latinos received a disproportionate level of high cost loans, even when they qualified for a lower rate and/or prime mortgage. Fannie Mae and Freddie Mac estimated that up to 50 percent of those who ended up with a subprime loan would have qualified for a mainstream, “prime-rate” conventional loan in the first place.⁹¹ According to a study conducted by the Wall Street Journal, as much as 61 percent of those receiving subprime loans would “qualify for conventional loans with far better terms.”⁹² Moreover, racial segregation is linked with the proportion of subprime loans originated at the metropolitan level, even after controlling for percent minority, low credit scores, poverty, and median home value.⁹³ The flood of high-cost, abusive loans in communities of color has artificially elevated the costs of homeownership, caused unprecedented high rates of foreclosures, and contributed to the blight and deterioration of these neighborhoods.

⁸⁷ Wilmarth (2007a). “In contrast to this absence of public enforcement action by the OCC against major national banks, state officials and other federal agencies have issued numerous enforcement orders against leading national banks or their affiliates, including Bank of America, Bank One, Citigroup, Fleet, JP Morgan Chase, and US Bancorp – for a wide variety of abusive practices over the past decade...”

⁸⁸ Bocian et al. (2006).

⁸⁹ Department of Housing and Urban Development (2000).

⁹⁰ Fishbein and Woodall (2006).

⁹¹ Center for Responsible Lending (2005); Acorn Fair Housing (2006).

⁹² Brooks and Simon (2007). See “Subprime Debacle Traps Even Very Creditworthy,” *Wall Street Journal*, December 3, 2007.

⁹³ Squires, et al. (2009).

The Federal Reserve is charged with writing rules under the Equal Credit Opportunity Act (ECOA), while the other banking agencies and the Department of Justice have enforcement authority. However, despite the problems mentioned above, fair lending enforcement by banking agencies has been anemic at best. These agencies have made few referrals for prosecution of fair lending violations. In fiscal year 2007-2008, the Federal Reserve referred only eight cases to the Justice Department. All of the banking agencies combined made only twenty-seven ECOA violation referrals in 2007.⁹⁴

Credit Card Lending

Congress and federal regulators received frequent warnings over the last 15 years that many credit card issuers were improperly underwriting loans and were using a range of questionable and deceptive practices that sharply increased debt loads on consumers.⁹⁵ These practices were very profitable for credit card issuers⁹⁶ but also unsustainable for financially vulnerable households.

Between January of 1994 and December of 2008, revolving consumer credit, most of which is credit card debt, rose from \$312 to \$989 billion, an increase of more than 300 percent.⁹⁷ Unprecedented losses for issuers and significant financial distress for consumers is evident in the sharply spiking delinquency and charge-off rates. During the first quarter of 2007, the charge-off rate for consumer credit cards was 3.88 percent at the 100 largest banks. By the third quarter of 2009, charge-offs were at 10.43 percent, the highest rate ever recorded.⁹⁸ Thirty-day delinquencies during the same period grew from 4.00 percent to 6.71 percent.⁹⁹

Consumer organizations and academics documented a number of unfair, deceptive and unsustainable lending practices and urged regulators and Congress to offer substantive protections for consumers. These practices included:

- The unjustified application of penalty and “default” interest rates that rose above 30 percent;
- Applying these interest rate hikes retroactively on existing credit card debt, which can lead to sharp increases in monthly payments and force consumers on tight budgets into credit counseling and bankruptcy;

⁹⁴ Saunders (2009b, p. 25-26).

⁹⁵ Consumer Federation of America (1997); Government Accountability Office (2006); Mann (2007); Barr-Gill (Seduction).

⁹⁶ Plunkett (2009a, p. 4-6).

⁹⁷ Federal Reserve (2010a).

⁹⁸ Federal Reserve (2009b).

⁹⁹ Federal Reserve (2009c).

- High and increasing “penalty” fees for paying late or exceeding the credit limit, sometimes using deceptive practices such as requiring that payments be received in the late morning of the due date;
- Aggressive credit card marketing towards and improper underwriting for college students and other young people;
- Requiring consumers to waive legal remedies through binding mandatory arbitration, often before an arbitrator with a conflict of interest;
- Sharply raising consumers’ interest rates because of a problem a consumer may be having paying another creditor, a practice known as “universal default.” By 2009, many card issuers claimed that they had eliminated this practice, but continued to permit it under sections in cardholder agreements that allowed them to change contract terms at “any time for any reason;”¹⁰⁰ and
- Lowering monthly minimum payment amounts that were required in order to encourage consumers to carry more debt and take longer to pay it off.¹⁰¹

As revolving debt grew sharply and reports of unfair or deceptive issuer practices increased, federal regulators were largely inactive. Between 1995 and 2007, the OCC issued only one public enforcement action against one of the ten largest credit card banks.¹⁰² During the same period, the OCC never issued a public enforcement order against the eight largest national banks for violating consumer lending laws.¹⁰³ Although the agencies did issue significant guidance in 2003 to require issuers to increase the size of minimum monthly payments that issuers require consumers to pay,¹⁰⁴ neither the Federal Reserve nor the OCC proposed any actions before 2008 (or asked for the legal authority to do so) to restrict unsustainable lending or unjustifiable fees and interest rates.

In December 2004, the Federal Reserve announced that it would consider major (and necessary) changes to credit card disclosures only, under Regulation Z. Consumer organizations applauded this initial step and urged action on substantive remedies as well. Specifically, the groups recommended that the Federal Reserve use its authority under the FTC Act to restrict

¹⁰⁰ Sherry (2007).

¹⁰¹ Plunkett (2009b, p. 13).

¹⁰² Plunkett (2009b, p. 12). Notably, this OCC action came only after the San Francisco District Attorney brought an enforcement action.

¹⁰³ Wilmarth (2007a).

¹⁰⁴ Federal Reserve Board, et al. (2003, p. 3).

unfair and deceptive practices.¹⁰⁵ In June of 2007, the Federal Reserve announced regulatory changes, but only regarding disclosures.

The lack of regulatory action to curb unfair and abusive practices spurred concern in Congress. Legislation addressing these practices was introduced in the House of Representatives in early 2008.¹⁰⁶ In May of that year, the Federal Reserve proposed UDAP rules, which it finalized in December. Congress moved to strengthen these rules and move up the implementation of the rule by enacting the Credit Card Accountability, Responsibility, and Disclosure Act (CARD Act) in May of 2009.¹⁰⁷

During this period, the OCC, the regulator of the largest credit card banks, questioned the need for key protections that were in both the proposed Federal Reserve rule and proposed legislation.¹⁰⁸ For example, during the summer of 2008, Comptroller of the Currency John Dugan wrote the Board of Governors of the Federal Reserve to urge them to insert two significant exceptions to key restrictions in the rule limiting the ability of card issuers to increase interest rates on card holders retroactively.¹⁰⁹ Tellingly, Dugan said that the restrictions “raise safety and soundness concerns” because they limited the ability of issuers to re-price their loans if issuers determined that the risk profile of the customer had worsened.¹¹⁰ This analysis of the proposed restrictions was nearly identical to concerns being raised by issuers at the time.¹¹¹ Not only does Dugan’s analysis ignore whether issuers’ re-pricing practices were fair to consumers, it appears to ignore some prudential concerns as well. For example, with charge-offs at that time starting an upward spiral to the highest levels on record, issuer re-pricing practices clearly could have contributed to the inability of some cardholders to afford the increasing size of their loans. Dugan appears not to have adequately considered whether allowing issuers to continue to use certain criteria to easily re-price their loans might ultimately lead not only to increased financial distress for cardholders, but exceedingly high losses for issuers.

Overdraft Lending

¹⁰⁵ National Consumer Law Center, et al. (2008).

¹⁰⁶ Credit Card Holder’s Bill of Rights, H.R. 5244, first introduced by Representative Carolyn Maloney in February 2008. Full text available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h5244ih.txt.pdf.

¹⁰⁷ See H.R. 627, enacted as Public Law No: 111-24 on May 22, 2009; and 74 C.F.R. 18, page 5498 Thursday, January 29, 2009.

¹⁰⁸ Williams (2008, p. 6-15).

¹⁰⁹ Dugan (2008a).

¹¹⁰ Id. (p. 1-2).

¹¹¹ Ireland (2008, p. 7). “...For these reasons, we believe that the Agencies should permit broader risk triggers for repricing existing balances in the final rule. These triggers might include a single occurrence of making a payment more than a few days late, over-the-credit limit, twice late or twice over-the-credit limit in 12 months or any other trigger based on activity on the account that leads to a similar increase in loss rates.”

Despite identifying serious problems with bank overdraft loan programs more than eight years ago, bank regulators did not act until November of 2009 to propose significant regulations to address some of these problems. In 2008, American consumers spent almost \$24 billion in fees on these cash advances of \$21.3 billion.¹¹² The FDIC has found that those most likely to be repeatedly charged overdraft fees are younger and lower income consumers.¹¹³ These loans have typically been provided by banks or credit unions without the knowledge or permission of consumers, in order to cover an account that has been overdrawn by writing a check, withdrawing funds at an ATM, using a debit card to make a purchase or pre-authorizing an electronic payment. Instead of rejecting the debit card purchase, or ATM withdrawal at no cost to the consumer, or returning the check unpaid with a bounced check fee, most depository institutions will now cover the overdraft and impose a fee of about \$35 for each transaction.¹¹⁴

Consumers typically do not apply for this form of credit or receive information on the comparable cost to borrow funds via overdrafts.¹¹⁵ They are generally not warned when a transaction is about to initiate an overdraft and are not given the choice of whether to borrow the funds at a high price or simply cancel the transaction. The Federal Reserve has carved out an exception under TILA for banks that provide overdraft loans, so they do not have to comply with TILA's disclosure requirements.¹¹⁶

Overdrafts are typically repaid within a few days when banks use set-offs to collect payment of the overdraft and fee from the consumer's next deposit. So the flat fees that are charged for very short-term extensions of credit result in very high interest rates. Assuming the median overdraft fee charge of \$27, a \$20 point of sale or debit overdraft repaid by the customer in two weeks would amount to an APR of 3,520 percent, and a \$60 ATM overdraft would incur an APR of 1,173 percent in two weeks.¹¹⁷ In addition, the FDIC's comprehensive study of the overdraft market found that over half of the large banks they surveyed process overdrafts from largest to smallest amounts, which causes more transactions to overdraw the account and generates more revenue.¹¹⁸

¹¹² Halperin and Smith (2007, p. 9).

¹¹³ Federal Deposit Insurance Corporation (2008b, v).

¹¹⁴ Fox (2009b, p. 3).

¹¹⁵ Federal Deposit Insurance Corporation (2008b, iii). The FDIC reports that over three-fourths of the banks it surveyed automatically pay overdrafts for a fee and seventy-five percent of those banks automatically enroll their customers in overdraft programs without their permission.

¹¹⁶ 12 C.F.R. 226.4(c)(3). Regulation Z carves out an exception to the definition of a finance charge and specifically excludes "charges imposed by a financial institution for paying items that overdraw an account."

¹¹⁷ Federal Deposit Insurance Corporation (2008b, p. 79).

¹¹⁸ *Id.* (iii).

In response to concerns about overdraft lending, bank representatives have said that consumers need to exercise more responsibility in avoiding overdrafts and have contended that their customers want the overdraft loan option.¹¹⁹ Bank representatives have also claimed that consumers want to have their largest, and presumably most important, debits paid first. However, polling has found that a large majority of the public wants debits paid in the order they are received.¹²⁰

When national banks began to face court challenges over the practice of clearing large debits first, the OCC issued guidelines that allowed the practices to continue.¹²¹ The OCC issued an Interpretive Letter allowing high-to-low check clearing when banks follow the OCC's considerations in adopting this policy. Those considerations include: the cost incurred by the bank in providing the service; the deterrence of misuse by customers of banking services; the enhancement of the competitive position of the bank in accordance with the bank's business plan and marketing strategy; and the maintenance of the safety and soundness of the institution.¹²² None of the OCC's considerations relate to consumer protection. The OTS, by contrast, advised thrifts that transaction-clearing rules (including check-clearing and batch debit processing) should not be administered unfairly or manipulated to inflate fees.¹²³

Federal banking regulators did recognize significant problems with overdraft programs in 2001. The OCC actually issued an Interpretive Letter that questioned "the complete lack of consumer safeguards" in an overdraft program that a third-party firm was marketing to banks.¹²⁴ However, the OCC appears to have changed its course as overdraft lending became more widespread and more lucrative for banks. The federal regulatory agencies issued broad guidance on overdraft loan practices in 2005, which they called "Best Practices." The Best Practices urged banks and credit unions to explain the impact of their transaction clearing policies,¹²⁵ and included several positive recommendations, including requiring affirmative consent for overdraft coverage and urging banks to consider limiting overdraft coverage only to checks, not debit cards and other transaction types. When asked by industry representatives to clarify, the agencies stated that the Best Practices were not going to be treated by examiners as enforceable

¹¹⁹ Carey (2009, p. 1-2).

¹²⁰ Consumer Federation of America (2009). A survey of 1,018 representative Americans for CFA found that 70 percent supported payment as debits are received.

¹²¹ Fox (2009b, Appendix C, p. 21).

¹²² 12 C.F.R. 7.4002(b).

¹²³ Office of Thrift Supervision (2005, p. 15).

¹²⁴ Office of the Comptroller of the Currency (2001).

¹²⁵ Department of Treasury (2005, p. 13).

under law. Given this strong signal from agencies that the Best Practices were merely a suggestion, not a requirement, it is not surprising that banks did not adopt most of the Best Practices. In fact, some of the practices the regulators identified as positive, such as declining debit card transactions instead of charging overdraft fees, have become less common since the Best Practices were adopted.¹²⁶

Eight years after the banking agencies themselves first identified problems with overdraft lending, the Federal Reserve proposed a binding rule on overdraft loans with significant consumer protections.¹²⁷ The Regulation E rule requires banks to receive affirmative consent from consumers before charging fees on debit card purchases and ATM withdrawals that overdraw consumers' bank accounts. It does not, however, require Truth in Lending Act coverage for overdraft fees as finance charges or prevent high-to-low manipulation of the order in which withdrawals are processed.

As with the credit card rule, the Federal Reserve acted just after key members of Congress introduced overdraft legislation. The legislation goes further in restricting overdraft loan practices than the proposed Federal Reserve rule in a number respects, most particularly by prohibiting depository institutions from charging customers more than one overdraft fee a month, or six per year. It also requires that debits are cleared in the order they are received and would apply the Truth in Lending Act to overdraft loans.¹²⁸

Payday Lending

Payday loans are small, short-term cash loans given on the expectation of payment in full from the borrower's next paycheck. Payday loans are also typically initiated with little or no underwriting or consideration of the borrower's ability to pay.¹²⁹ Lenders are assured payment of payday loans through the practice of "check holding." At the time of the loan, lenders take a personal check to be held until the due date or are allowed electronic access to the borrower's bank account in the amount of the loan plus the fee.¹³⁰ This method ensures priority repayment of the amount owed or, at least, repeated payment of the finance charge to renew the loan and

¹²⁶ Calhoun (2009).

¹²⁷ Federal Reserve Board (2009d).

¹²⁸ U.S. Senate (2009); U.S. House (2009).

¹²⁹ Fox (2009a, p. 5).

¹³⁰ Fox (2009a, p. 4).

keep the check used to obtain the loan from bouncing. Unlike overdraft loans, the Federal Reserve has determined that payday lending is subject to TILA requirements.¹³¹

These loans are unsecured and have high fees relative to the size of the loan.¹³² Payday loans range from \$100 to \$1,000, depending on state legal maximums. The typical loan term is about two weeks. The finance charge for a payday loan ranges from around \$15 per \$100 borrowed to \$30, resulting in annual interest rates from 391 percent to 782 percent for a two week extension of credit. As a result of these factors and the very short repayment schedule, borrowers are often induced to roll over their loan repeatedly.¹³³

In 2008, storefront payday lenders provided \$35 billion in credit to consumers and generated \$5.5 billion in revenues. At the end of 2008, there were 22,300 payday loan stores, down 5.6 percent in 2008, due to increasing legislative and regulatory restrictions on the sale of payday loans in some states. Internet payday lending volume is estimated at \$7.1 billion.¹³⁴

Payday loan users tend to have less income, lower wealth, fewer assets, lower levels of education and less debt than families without payday loans. They are more likely to be minorities, single female head of household, and younger than non-payday loan users.¹³⁵ The average payday borrower takes out nine loans a year on a consecutive basis, with more than one transaction per month.¹³⁶

The FDIC has identified twenty-one practices that alone or in combination with other practices may indicate predatory lending.¹³⁷ Payday lending was specifically listed as a potential predatory practice.¹³⁸ Among other indicators of predatory lending were abusive collection practices, balloon payments, excessive interest rates, “excessive fees not justified by the costs of services provided and the credit and interest rate risks involved,” and “high loan-to-value ratio that may negatively impact a borrower’s ability to avoid unaffordable debt.”¹³⁹ Most or all of these elements are present in most payday loan transactions.

Consumer organizations have also expressed significant concern about the practice of check holding, an unsafe banking practice that exposes consumers to coercive collection tactics. Lenders induce consumers to perform an act (deliberately writing a check without sufficient

¹³¹ § 226.2(a)(14)-2

¹³² Federal Deposit Insurance Corporation (2006).

¹³³ Parrish and King (2009).

¹³⁴ Stephens Inc. (2009, p. 1, 5).

¹³⁵ Logan and Weller (2009, p. 1).

¹³⁶ Fox (2009a, p. 7).

¹³⁷ Federal Deposit Insurance Corporation (2006, p. 5-6).

¹³⁸ *Id.* (p. 6).

¹³⁹ Federal Deposit Insurance Corporation (2006, p. 6).

funds on deposit to cover the check) that otherwise can lead to civil or criminal prosecution. (Consumers are not guilty of civil or criminal bad check laws in most states for failure to repay a payday loan since these lenders are given explicit authorization to base loans on unfunded checks.) Moreover, when a consumer bounces a check given for a payday loan it can trigger excessive insufficient fund fees or overdraft fees, furthering a cycle of economic distress.¹⁴⁰ Defenders of payday lending assert, in response, that the product provides a valuable safety net for consumers and that it can shield consumers from credit card defaults and excessive insufficient fund and overdraft fees.¹⁴¹

Payday lending is authorized by state laws or regulations in thirty-four states and is permitted for licensed lenders with no rate cap in Wisconsin. Fifteen states and the District of Columbia do not authorize high-cost or single pay period loans secured by personal checks.

Payday lending has not been solely a state regulatory matter. Federal regulators also fueled the extraordinary growth of payday lending during the late 1990s and early 2000s by allowing banks to partner with loan companies to evade state laws. By claiming the right to “export” weak regulations from the states where their bank partners were based, payday lenders were able to charge consumers much higher rates than state laws permitted and use other loan features that were prohibited.

In 2001, the OCC was the first federal regulator to order institutions to cease their payday loan programs, followed by the OTS in 2003.¹⁴² The Federal Reserve influenced its only payday loan bank to exit this business as well. The agencies focused entirely on the safety and soundness implications to financial institutions that participated in “rent-a-bank” payday lending, rather than the financial consequences for consumers.¹⁴³ After the other federal regulators began stopping the practice, FDIC regulated banks became a haven for payday lenders who partnered with state-chartered banks that wanted to participate in the lucrative payday lending trade. In 2003, it permitted the First Bank of Delaware to switch to its supervision after the Federal Reserve imposed significant regulatory restrictions on the bank’s payday business. In 2006, the FDIC closed down payday lending operations by institutions it regulated.¹⁴⁴

¹⁴⁰ Fox (2009a, p. 7).

¹⁴¹ Wilson et al. (2008, Appendix A, Table 1), comparing average 391 percent APR on payday loan with average 478 percent APR on bounced check.

¹⁴² Plunkett (2009b, Appendix 3, p. 52).

¹⁴³ Office of the Comptroller of the Currency (2003b).

¹⁴⁴ Plunkett (2009b, Appendix 3, p. 53).

The Federal Reserve has also facilitated the growth of and financial risks associated with internet payday lending by rejecting requests, first initiated in 2006, that it prevent these lenders from evading consumer protections in the Electronic Fund Transfer Act (EFTA).¹⁴⁵ EFTA prohibits basing the extension of credit with periodic payments on a requirement to repay the loan electronically.¹⁴⁶ However, because the Federal Reserve has not acted to extend that protection to single-payment loans that can be renewed, internet payday lenders currently have first claim on the direct deposit of the borrower's next paycheck or exempt federal funds, such as Social Security, SSI, or Veterans Benefit payments. The Federal Reserve has also not prohibited the use of demand drafts (unsigned paper checks) despite a request by the National Association of Attorneys General and consumer organizations. As a result, online payday lenders can use bank account information provided in loan applications to create unsigned checks and continue to take funds from consumers' bank accounts, even when consumers exercise their right to revoke authorization to pay loans electronically.

Major Structural Reasons for Consumer Protection Regulatory Failures

Since the housing and economic crisis became severe in 2008, policymakers throughout the country have been debating the major reasons for the inadequate regulatory response to serious problems in the mortgage and consumer credit markets that helped cause and sustain this crisis. The main points of dispute involve the extent to which regulators failed because of their anti-regulatory philosophy, significant gaps in the laws that did not give them sufficient regulatory authority, or serious flaws in the regulatory structure.

At the federal level, nearly all regulatory failures that occurred in the mortgage and consumer credit markets were in areas where federal regulators had some authority to act and either chose not to do so or acted too late to stem serious problems. An ideological predisposition or anti-regulatory bias by federal officials appears to have been the main reason they did not attempt to rein in abusive mortgage lending before it triggered the housing and economic crises, or before unsustainable consumer credit lending left consumers vulnerable to the economic crisis. The regulators' guiding principle was the deregulatory philosophy expressed by Chairman Greenspan that markets are self correcting and that the risks of over-regulation

¹⁴⁵ Plunkett (2009b, p. 18).

¹⁴⁶ Reg E, 12 C.F.R. § 205.10(e). 15 U.S.C. § 1693k states that "no person" may condition extension of credit to a consumer on the consumer's repayment by means of a preauthorized electronic fund transfer.

were far more severe than the risks of under-regulation. (This philosophy was developed and exercised in a political climate of unified industry and significant Congressional opposition to the increased use of regulatory authority that existed.)

Inadequate laws can be blamed in some cases for regulatory failures. The subprime mortgage contagion started with non-bank lenders, which were, initially at least, not subject to strong statutory or regulatory oversight by the states. However, unlike the huge statutory gaps and prohibitions that existed at the federal level regarding the capital market regulation of financial derivatives, such gaps did not exist at the federal or state level regarding oversight of the mortgage and consumer credit markets – at least not for long. It is true that Congress was pressed for many years to enact laws to combat “predatory lending” in the mortgage markets, which would have given regulators strong statutory direction and enforcement tools to combat abusive mortgage lending. Although such legislation has passed the House of Representatives, the Senate has still not approved it.¹⁴⁷ Congress also considered legislation for many years regarding unfair and deceptive credit card practices, enacting legislation in May of 2009. Legislation to regulate overdraft loans has been introduced by senior members of Congress since 2005.

However, in each of these problem areas, regulators had substantial existing authority to act. As detailed above, the Federal Reserve had authority under HOEPA to establish uniform standards for unfair and deceptive acts and practices (UDAP) for depository and non-depository lenders alike and did not do so until July of 2009. A majority of states acted long before federal regulators to rein in abusive mortgage lending practices and were blocked by aggressive preemptive action by the OTS and OCC, which did little or nothing to use their authority to forcefully challenge the underwriting standards of banks and their non-bank subsidiaries.

The Federal Reserve had similar UDAP authority over credit card and overdraft practices as well, and, despite being encouraged to do so for many years, did not propose rules until May, 2008 and November, 2009, respectively. In both cases, the circumstantial evidence is strong that the Federal Reserve was prodded into action at least in part by a desire to preempt likely Congressional action on these issues and threats by Congress to take away UDAP rule-making authority.¹⁴⁸

¹⁴⁷ HR 4173, VII Mortgage Reform and Anti-Predatory Lending Act

¹⁴⁸ U.S. National Archives and Records Administration (2007, p. 37-38). The Chairman of the House Financial Services Committee, Barney Frank, said, “I am going to make a statement with regard to your rulemaking authority: use it or lose it...And I think I speak here probably for the majority of this committee. If the Fed doesn’t start to use that authority to roll out the rules, then we will give it to somebody who will use it. You reinforce my sense that the Fed is not the best place to do consumer protection.”

The experience with similar regulatory failures internationally also demonstrates that regulatory structure was an important, but not overriding factor, in how successful various countries were in stemming problems in the mortgage and consumer credit markets. The Turner investigation of the reasons for regulatory failure in the United Kingdom concluded that, “it is noticeable that relative national success in the face of the financial crisis seems to be as uncorrelated with the choice of structure as it is with supervisory style.”¹⁴⁹ The United Kingdom, for example, has a unified Financial Services Authority (FSA) that provides prudential and consumer protection regulation of banking, credit, securities and insurance. However, despite the dramatic differences in the regulatory structures of the UK and the US, the UK fared no better during the financial crisis than the United States and, in some cases, worse. The Turner Review found that the FSA’s “light touch” regulatory philosophy and weak mortgage lending standards were major reasons for these failures. Similar to regulators in the United States, the FSA viewed markets generally as self-correcting and product regulation as harmful because it would inhibit innovation. The FSA was also blind to the systemic risks that flowed from this regulatory approach.¹⁵⁰ Correspondingly, the major factors in Canada’s relative success in avoiding the regulatory failures that occurred in the US and the UK appears not to have been the regulatory structure per se, but stringent requirements for mortgage borrowers and lenders and leverage ratios regarding investment by Canadian banks.¹⁵¹

While the regulatory architecture in the US, the UK and Canada appear not to have been determinative of mortgage and consumer credit regulatory outcomes, structure clearly did have a significant impact. In the UK, for example, the Turner Review concluded that combined prudential and consumer regulation was a significant factor in the FSA overlooking serious prudential problems with the banks it regulated.¹⁵² In the US, structural flaws in the federal regulatory system – including combined consumer and prudential regulation -- appear to have magnified the anti-regulatory bias that existed and encouraged regulators to overlook or ignore their consumer protection mission. Structural flaws also appear to have compromised the independence of banking regulators, created a dynamic in which agencies appeared to compete against each other to weaken standards, and ultimately led to a rulemaking process that was cumbersome and ineffectual. These structural weaknesses threatened to undermine even the

¹⁴⁹ Financial Services Authority (2009, p. 91).

¹⁵⁰ *Id.* (p. 87).

¹⁵¹ *Id.* (p. 90).

¹⁵² Financial Services Authority (2009, p. 92).

most diligent policies and intentions.¹⁵³ They complicated enforcement and vitiated regulatory responsibility to the ultimate detriment of consumers.

Consumer Protection Regulation Has Not Been a Priority for Federal Regulators

As mentioned above, federal consumer protection authority for banking, credit and payments systems is split between seven federal agencies that variously hold exclusive, joint, or concurrent authority to enforce almost twenty consumer protection statutes. Only the Federal Trade Commission, which has no authority over depository institutions, has consumer protection as a core mission. Three of the five banking agencies have rule writing authority for the institutions they regulate. No agency is designated as a lead agency regarding consumer protection overall, although the Federal Reserve often assumes a leading role in writing rules. The FFIEC is supposed to assume a coordinating role between the agencies but has no authority of its own to require agencies to act. As law professor Adam Levitin has said, “the result is that because consumer protection is everyone’s responsibility, it becomes no one’s responsibility, and accountability and performance suffer therewith.”¹⁵⁴

Among the federal banking regulators, “consumer protection regulation and supervision was added to the agencies’ responsibilities relatively late in their histories, and it has never fit snugly in their missions, structures, or agency cultures,” according to one Treasury official.¹⁵⁵ The statutes that created and empowered the banking agencies do not include a general requirement to protect consumers.¹⁵⁶ The protection of the safety and soundness of regulated institutions was a major reason each of the banking agencies was created and remains a high priority today, creating tension with consumer protection oversight (see section below).¹⁵⁷ The consumer-focused statutes mentioned above have been enacted within the last forty-two years, well after the Federal Reserve, OCC, FDIC, NCUA and the predecessor to the OTS were created, and then cobbled onto the agencies’ other missions. No effort, until very recently, has been made by an agency to broaden its authorizing statute to include consumer protection. The

¹⁵³ Jackson (2009, p. 8).

¹⁵⁴ Levitin (2009c, p. 4).

¹⁵⁵ Barr (2009, p. 3).

¹⁵⁶ For the OCC, see Chapter 106, 13 Stat. 99 (1864). For the Federal Reserve Board, see Pub. L. No. 63-43 (1913). For the FDIC, see 74-305 (1935). For OTS, see Pub. L. No. 101-73 (1989).

¹⁵⁷ The Federal Reserve Bank was created in response to the failure of several banks during the Financial Panic of 1907. Federal Reserve (2009e). The FDIC was established to ensure confidence in the American banking system in the wake of widespread bank failures during the Great Depression. Bovenzi (2007). The OTS has its roots both in the Great Depression, when its predecessor agency, the Federal Home Loan Bank Board (FHLBB), was created; and in the Savings and Loan Crisis of the 1980’s, when many FHLBB powers were transferred to OTS. (OTS) The OCC, the oldest bank regulator, was created in 1863 to finance the nation’s civil war debt and reduce financial uncertainty. (OCC)

Federal Reserve acknowledged this situation last year by formally recommending that consumer protection be a statutorily mandated mission, on par with setting monetary policy.¹⁵⁸

The fact that consumer protection was not an established priority for any one regulatory entity meant that no agency had the incentive to develop market-wide expertise regarding consumer protection trends and concerns. For example, of the 128 economists focused on research and statistics identified by the Federal Reserve on its staff list, only 15 identify consumer finance as a focus.¹⁵⁹ The agencies failed in particular to collect and effectively analyze data regarding the consumer impact of subprime and Alt A mortgage lending, as well as increasing unfair and deceptive credit card practices and growing credit card debt.¹⁶⁰ As early as a decade before the subprime mortgage market imploded, information and data were widely available about the inordinately high rate of failure by the largest subprime lenders, state and FTC actions against these companies for abusive lending practices, unusually high delinquency and foreclosure rates regarding their loans, and predictions that subprime lending would ultimately result in a decline, not an increase, in home ownership rates.¹⁶¹

The division of statutory responsibility and rule writing and enforcement authority among banking agencies has created a policymaking process that is fractured, complicated and inefficient. For example, the OCC is the paramount enforcer of credit card rules because it regulates the handful of national banks that dominate the credit card marketplace. The Federal Reserve, however, not the OCC, has rule writing authority and has taken the lead in writing new credit card rules under Regulation Z.¹⁶² As stated above, the OCC resisted the imposition of some of the most significant new rules, which raises a question as to whether the OCC will do an effective job in enforcing these requirements.¹⁶³

Another example of the illogical division of labor between agencies involves mortgage lending. HUD has authority over mortgage closing documents and lender compensation practices like “yield spread premiums” under RESPA, but the Federal Reserve is required to oversee disclosure of mortgage interest rates and loan sales practices under TILA and HOEPA. No single agency had authority to holistically evaluate all of the problematic compensation, sales

¹⁵⁸ Duke (2009, p. 17).

¹⁵⁹ Federal Reserve Board (2010b).

¹⁶⁰ Federal Reserve Board (2006b, p. 12). The Federal Reserve dismissed concerns that a significant number of households might have been offered and taken on unsustainable levels of credit card debt by assessing debt loads only in the aggregate. “Neither the debt service ratio nor the financial obligations ratio suggests that consumers in the aggregate face excessive debt service burdens.”

¹⁶¹ Keest (2009, p. 9-10).

¹⁶² U.S. National Archives and Records Administration (2009).

¹⁶³ Dugan (2008a).

and disclosure practices in the subprime lending market. Efforts to protect regulatory “turf” and prerogatives hampered more effective collaboration between the agencies.

Balkanized regulatory authority has also resulted in weak, sluggish or uneven regulation, and sometimes all three. When agencies do collaborate to apply consumer protections consistently to the institutions they regulate, the process has been very slow, as the GAO has found. “Efforts by regulators to respond to the increased risks associated with new mortgage products also have sometimes been slowed in part because of the need for five federal regulators to coordinate their response.”¹⁶⁴ By the time HOEPA rules were finalized in July of 2008, many subprime mortgage lenders had gone out of business. Regulators waited so long to propose and then finalize rules prohibiting unfair and deceptive credit card practices that Congress was already well along in the process of enacting a law that turned out to be stronger in many respects.¹⁶⁵ The eight-year delay in proposing rules since regulators first expressed concerns about unfair and deceptive overdraft loan practices may lead to the same result.

One of the reasons for these delays has often been that regulators disagree among themselves regarding what regulatory measures must be taken. The course of least resistance in such cases is to do nothing or to prolong the process. Although the credit card rule adopted in December of 2008 by federal regulators was finalized in a very short period of time over strong objections from the OCC, it appears that these objections were one of the reasons that federal regulators delayed even beginning the process of curbing abusive credit card lending practices until May of that year.

On the rare occasions that agencies act unilaterally to impose formal or informal rules on the institutions they oversee that are more stringent than those applied by other regulators, it not only results in uneven rules for institutions, but also in uneven standards for consumers who buy or use identical products or services. A consumer doing business with a national thrift is protected from multiple overdraft charges that occur because of manipulation of the debit payment order. A consumer doing business with a national bank is not. Moreover, if an agency regulating only a slice of the market acts unilaterally to apply more stringent oversight to the institutions it regulates, it is putting these institutions at a “competitive disadvantage” relative to other depository institutions.

¹⁶⁴ Government Accountability Office (2009, p. 43).

¹⁶⁵ Public Law 111-24.

Consumer Protection Was Subordinated to Prudential Regulation

Theoretically, protecting consumers through business conduct regulation and assuring the financial health of depository institutions through prudential regulation should be complementary, not competing, missions. As Federal Reserve Governor Elizabeth Duke has stated in Congressional testimony, “these missions reinforce one another. For example, sound underwriting benefits consumers as well as the institution, and strong consumer protections can add certainty to the markets and reduce risks to the institutions.”¹⁶⁶

In fact, a clear lesson of the current crisis is that a shortsighted view of consumer protection and bank solvency as opposing objectives is flawed. If prudential regulators had focused more on protecting consumers from unsustainable loans, they would also have done a much better job of protecting the safety and soundness of firms like Countrywide and Washington Mutual. Combined prudential and business conduct regulation can also be more efficient and cost-effective, as stated by the Turner Review:

Combining prudential supervision with conduct of business supervision has considerable advantages, both in ensuring a cost efficient interface with regulated firms, and in ensuring that linkages between conduct and prudential issues are identified (e.g. overly aggressive credit sales approaches can create both conduct detriment to customers and prudential risks to banks). The benefits of integrating conduct and prudential concerns may moreover increase in future if product regulation (e.g. of mortgage loan-to-value or loan-to-income ratios) is used as both a prudential and customer protection tool...¹⁶⁷

Among U.S. bank regulators, however, this theory seems to have broken down in practice. Though the link between consumer protection and safety and soundness is now obvious, the two functions are not the same and do conflict at times, as acknowledged by a U.S. Treasury Department official’s comment that, “it was thought that supervising the banks for their effective management of ‘reputation risk’ and ‘litigation risk’ – aspects of a safe and sound institution – would ensure the banks treated their customers fairly. It didn’t.”¹⁶⁸

Some financial practices and products are highly profitable and do not endanger the safety and soundness of regulated institutions, even though they may be deceptively offered or have a financially harmful effect on many consumers. The actions of federal regulators in such cases seemed to demonstrate a view that their consumer protection mission was secondary to

¹⁶⁶ Duke (2009, p. 1).

¹⁶⁷ Financial Services Authority (2009, p. 92).

¹⁶⁸ Barr (2009, p. 3).

safety and soundness and might even be in conflict with it.¹⁶⁹ For example, after more than six years of effort by consumer organizations, federal regulators finally proposed consumer protection rules on overdraft loans in November 2009. Given their longstanding inaction on this issue, it is reasonable to assume that regulators were either unconcerned with the consumer impact of this product or viewed restrictions on overdraft loans as an unnecessary financial burden on banks that extend this form of credit.

Additionally, because regulators appeared to be overly enamored of technological innovations that allowed creditors to segment markets and, theoretically, price accurately for risk, regulators appear not to have effectively ascertained in some cases when lending practices might eventually lead to a serious increase in losses for creditors, threatening their financial stability.¹⁷⁰ In truth, the goals of prudential regulation are quite different from business conduct regulation, as are the methods that regulators must use to effectively implement each, as explained in one comparative study of international financial regulation:

There is a fundamental difference between the objectives of prudential regulation and those of business conduct regulators to invoke different strategies and approaches. In the case of prudential regulation, the regulator assumes a more cooperative relationship with the financial institution. The regulator exists to assist the financial institutions. Its role is to set standards and monitor maintenance of those standards by the financial institution. To the extent a financial institution fails to meet certain standards or the regulator identifies a possible threat to the soundness to the financial institutions, the role of the regulator is to work with the financial institution and find a solution. In contrast, a business conduct regulator is frequently in an adversarial position relative to the financial institution. This regulator is effectively a representative of the customers and investors, using its rulemaking powers to impose new requirements on financial institutions and its enforcement powers to discipline and punish financial institutions for business conduct violations.¹⁷¹

The prudential regulatory focus on supervision and examination of financial institutions is unsuited in many ways to enforcement of consumer protection requirements. Federal regulators have focused, until recently, almost exclusively on bank examination and supervision to check for compliance with consumer requirements, a process that lacks transparency. This

¹⁶⁹ Occasionally, safety and soundness concerns have led regulators to propose consumer protections, as in the eventually successful efforts by federal banking agencies to prohibit “rent-a-charter” payday lending mentioned above, in which payday loan companies partnered with national or out-of-state banks in an effort to skirt restrictive state laws. However, from a consumer protection point-of-view, this multi-year process took far too long. Moreover, the outcome could have been different if the agencies had concluded that payday lending would be profitable for banks and thus contribute to their soundness.

¹⁷⁰ Dugan (2008b).

¹⁷¹ Pan (2009, p. 22).

process gives bank regulators a high degree of discretion to negotiate out of public view with bank officials to decide what types of lending are harmful to consumers.¹⁷²

While this behind-the-scenes approach may be appropriate for quietly fixing prudential problems without increasing the “reputation risk” of a financial institution, it is often not appropriate for consumer compliance. Financial regulatory enforcement actions are a matter of public record, which can have a positive impact on other financial services providers who might be engaged in the same practices and provides information to consumers on financial practices that have been sanctioned by regulators. In fact, widespread abusive lending in the credit markets has discredited claims by bank regulators like the Comptroller of the Currency that a regulatory process consisting primarily of supervision and examination results in a superior level of consumer protection compared to taking public enforcement action against institutions that violate laws or rules.¹⁷³

Administration officials have also criticized federal supervisory activities for focusing on narrow compliance questions rather than more significant concerns.

It should not have come as a surprise that the agencies’ ‘check the box’ approach to consumer compliance supervision missed the forest for the trees. Examiners are well trained to ascertain whether the annual percentage rate on a loan is calculated as prescribed and displayed with a large enough type size. Equally or more important questions – Could this consumer reasonably have understood this complicated loan? Is this risky loan remotely suitable for this consumer? – are not a priority for an agency whose main job is to limit risks to banks, not consumers.¹⁷⁴

Michael Taylor, a former officer at the Bank of England and influential author on structural issues,¹⁷⁵ points to regulatory failures on both sides of the Atlantic as evidence that it is unlikely that any regulatory agency can juggle both prudential and business conduct regulation well.

Regulatory agencies with too many tasks and too many different objectives are at risk of doing them badly. The point is made most clearly by the combination of

¹⁷² Wilmarth (2007a). “Findings made during compliance examinations are strictly confidential and are not made available to the public except at the OCC’s discretion. Similarly, the OCC is not required to publish the results of its safety-and-soundness orders....Thus, the OCC’s procedures for compliance examinations and safety-and-soundness orders do not appear to provide any public notice or other recourse to consumers who have been injured by violations identified by the OCC.”

¹⁷³ Dugan (2007). “...ours is not an ‘enforcement-only’ compliance regime – far better to describe our approach as ‘supervision first, enforcement if necessary,’ with supervision addressing so many early problems that enforcement is not necessary.”

¹⁷⁴ Barr (2009).

¹⁷⁵ Taylor developed the concept of what he called “twin peaks” regulation: setting up separate business conduct and prudential regulatory agencies for banking and credit, securities and insurance. Several countries have since adopted this structure, including Australia and the Netherlands.

prudential and consumer protection regulation. The Turner Review has acknowledged that the FSA did not devote sufficient resources to prudential regulation prior to the crisis. The FSA's management chose to emphasize high-frequency events such as consumer complaints rather than low frequency but high impact events, such as bank failures. The Federal Reserve made the opposite decision, and has been criticized for its failure to use its consumer protection powers. When prudential and consumer protection regulation are combined in a single agency, one of them is likely to be done badly.¹⁷⁶

The disparity in agencies' focus on consumer protection versus "safety and soundness" is also apparent in the relative resources that agencies appear to devote to the two goals and in the strategic priorities they identify. These priorities have frequently minimized consumer protection relative to prudential and other regulatory priorities and have included reducing regulatory restrictions on the institutions they oversee.¹⁷⁷ For example, the Federal Reserve, the agency with perhaps the largest mandate to protect consumers, allocated just 5 percent of its total expenditures in 2008 and 2009 to the Division of Consumer and Community Affairs.¹⁷⁸ The Division conducts consumer compliance exams and enforcement actions, writes rules, and handles consumer complaints, among other responsibilities. Only six percent of all bank examinations it conducted in 2008 involved compliance with consumer laws.¹⁷⁹

The Federal Reserve's Macroeconomic Outlook and Consumer Protection Regulation

Questions have also been raised about whether the Federal Reserve's *other* roles—its priority mission in setting monetary policy—and its significant, ad hoc involvement in systemic risk regulation to protect the economy in the last year—leave it well-equipped to perform consumer regulation. As consumer law attorney Lauren Saunders stated in Congressional testimony:

¹⁷⁶ Taylor (2009).

¹⁷⁷ For example, in 2007, 2008 and 2009, the OTS cited consumer protection as part of its "mission statement" and "strategic goals and vision." However, in identifying its strategic priorities for how it would actually spend its budget during those fiscal years, only part of one of eight priorities was directly related to consumer protection in 2007 ("data breaches"), only one of eleven in 2008 (consumer compliance exams) and only two of eleven in 2009 (promoting loss mitigation to reduce mortgage foreclosures and consumer compliance exams). On the other hand, OTS identified both "Regulatory Burden Reduction" and "Promotion of the Thrift Charter" as major strategic budget priorities in all three years. Office of Thrift Supervision (2007b, p. 4); Office of Thrift Supervision (2008, p.4); Office of Thrift Supervision (2009, p.4). Similarly the OCC identified consumer protection as one of four "strategic goals" in its five-year strategic plan, but only seven of 27 specific objectives are related to consumer protection or community development. Office of Comptroller of the Currency (2007, p.5).

¹⁷⁸ The Division of Consumer and Community Affairs was budgeted to receive \$38.2 million for the two-year period of 2008 and 2009, 5.2 percent of the Federal Reserve Board's total operating budget of \$736.4 million spent during that period. Federal Reserve Board (2009a, p. 13, 35).

¹⁷⁹ Federal Reserve Board (2008, p. 98, 137). In FY2008, the Federal Reserve conducted 268 consumer compliance examinations of regulated banks. By comparison, it conducted prudential examinations in 2008 of 486 small member banks, 500 large bank holding companies, and 3,048 small bank holding companies. Consumer examinations represented 6.2 percent of the total number undertaken.

The Federal Reserve has far too much on its plate and comes from a very different perspective. Though the agency certainly could have done better, in retrospect it may simply have been unfair to expect the FRB to play so many different roles. Its governance structure, the role of the regional banks, its focus on the profitability and health of the institutions it supervises, and its macro role in monetary policy all leave consumer protection as an afterthought. With so much of its time, energy and budget focused on entire portfolios, large institutions, and indeed on the state of the entire economy, the needs of individual families and the ins and out of how products work one-on-one are simply not part of the agency's mindset.¹⁸⁰

No less an authority on the Federal Reserve's strengths and weaknesses than former Board of Governors' Chairman Alan Greenspan has acknowledged that it is too focused on broader economic issues to be effective at ferreting out specific lending abuses that affect particular consumers.¹⁸¹ In fact, lending experts and consumer organizations repeatedly provided Federal Reserve governors and staff with detailed evidence of growing lending abuses around the country but were told that they could not demonstrate the macroeconomic impact that would be sufficient to provoke intervention by the Federal Reserve.¹⁸²

The new law gives the Federal Reserve even more macroeconomic responsibilities to formally regulate systemic risk in the financial sector.¹⁸³ Two former Federal Reserve Governors, Frederic Mishkin and Laurence Meyer,¹⁸⁴ have said that systemic risk mission is too incongruent from the consumer protection mission to fit well in one agency.

I believe that the Federal Reserve should give up its role as a consumer protection regulator....The skills and mindset required to operate as a consumer protection regulator is fundamentally different from those required by a systemic regulator. Protecting consumers involves setting and then enforcing the appropriate rules under a transparent legal framework. The orientation of an effective systemic regulator must be different from that of a rule-enforcing consumer protection or conduct of business regulator. A regulator charged with both enforcing rules and

¹⁸⁰ Saunders (2009b, p. 28).

¹⁸¹ Appelbaum (2009a). "The Fed also minimized repeated warnings about mortgage lending abuses in part because it was an institution dominated by big-picture economists focused on the health of the broader economy rather than the problems faced by individual borrowers," Greenspan said in an interview that he did not think the Fed was suited to policing lending abuses because of its focus on broader issues, but he added, "I'm not sure anyone could have done it better."

¹⁸² Appelbaum (2009a). "The response we were getting from most of the governors and staff was, 'All you're able to do is point to the stories of individual consumers, you're not able to show the macroeconomic effect,'" said Patricia McCoy, a law professor at the University of Connecticut who served on the Fed's consumer advisory council from 2002 to 2004. "That is a classic Fed mindset. If you cannot prove that it is a broad-based problem that threatens systemic consequences, then you will be dismissed."

¹⁸³ Dodd-Frank Act, Title I, Subtitle A.

¹⁸⁴ Meyer (2009, p. 4,5). "If something is to be given up, the most obvious choice is consumer protection and community affairs. These are not seen around the world as core responsibilities of central banks."

managing systemic risk may end up devoting too much of its attention to rule enforcement.¹⁸⁵

Regulators Were Not Independent of Industry Influence

The regulatory structure is organized according to increasingly irrelevant distinctions between the type of financial institution that is lending money rather than the type of product being offered to consumers. This system of narrow regulatory “silos” by itself threatens the independence of regulators and encourages them to take steps that might be beneficial to their institutional interests but are harmful to the cause of effective regulation. As Professor Howell Jackson of Harvard Law School testified before Congress:

“Not only does our siloed approach to financial regulation produce an uneven regulatory structure, it makes individual agencies more vulnerable to regulatory capture. When the sole task of a regulatory agency is to oversee a single subsector of the financial services industry, the agency is much more likely to interpret its mission as ensuring the survival and growth of the subsector it oversees.... Similarly, in an effort to attract more depository institutions to federal charters, the Comptroller of the Currency and the Office of Thrift Supervision engaged over the past decade in what many regarded as the cavalier preemption of state consumer protection laws in order to provide national banks and federal thrifts a competitive advantage over their competitors with state charters. In my view, the narrow jurisdictional mandates of these regulatory agencies contributed to an excessive degree of preemption, weakening protections for consumers and facilitating an explosion of ill-advised mortgage originations and excessive growth in consumer credit.”¹⁸⁶

The tendency of regulators in an institution-centered system to identify with the narrow interests of regulated entities is exacerbated when financial institutions are allowed (and have frequently exercised their right) to choose the regulatory body that oversees them and to switch freely between regulatory charters at the federal level and between state and federal charters, taking the assessments they pay regulators with them. Many state chartered institutions have chosen to switch to federal charters in recent years, including some of the largest financial institutions in the country. Charter switches by JP Morgan Chase, HSBC and Bank of Montreal (Harris Trust) in 2004-05 alone moved over \$1 trillion of banking assets from the state to the

¹⁸⁵ Mishkin (2009, p. 2).

¹⁸⁶ Jackson (2009, p.7).

national banking system, increasing the share of assets held by national banks to 67 percent from 56 percent, and decreasing the state share to 33 percent from 44 percent.¹⁸⁷

Charter conversions also move from the federal to the state level. *The Washington Post* reported last year that 240 banks had converted from federal to state charters since 2000. State regulators promote their lower assessment rates, their accessibility and their knowledge of local financial conditions. At least 30 of these banks were facing pending federal regulatory actions when they shifted to a state charter.¹⁸⁸ State chartered banks can also change the federal agency that supervises them without switching charters as well, as First Bank of Delaware did in 2003 when it pulled out of the Federal Reserve System and moved to FDIC supervision in order to continue “rent-a-charter” payday lending.¹⁸⁹

At the federal level, perhaps the most notorious switch that occurred involved Countrywide Financial Corporation in 2007, which became the largest lender in the country by promoting questionable subprime mortgage loans on a massive scale. A decision by Countrywide to switch its charter to the OTS in the spring of 2007 played a significant role in the severe solvency problems it later experienced, which resulted in its forced sale to Bank of America.¹⁹⁰ OTS regulators promoted the agency to Countrywide as a more “lenient” regulator than the OCC and the Federal Reserve.¹⁹¹ The leniency took the form of continued exceptions to various requirements for option adjustable rate mortgages that later proved to be a major source of losses for the bank.¹⁹²

The ability of regulated institutions to “charter shop” combined with aggressive efforts by federal regulators to preempt state oversight of these institutions appears to have affected the independence of the OTS and the OCC. The OCC in particular appears to have used its broad preemptive authority over state consumer protections and its aggressive legal defense of that authority as a marketing tool to attract depository institutions to its charter.¹⁹³

¹⁸⁷ Wilmarth (2006, p. 102, 105-106).

¹⁸⁸ Appelbaum (2009b).

¹⁸⁹ Plunkett (2009a, Appendix 3, p. 53).

¹⁹⁰ Applebaum and Nakashima (2009).

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ For a detailed analysis of OCC efforts to promote its charter, see brief amicus curiae of Center for Responsible Lending et al in the case currently before the Supreme Court, *Cuomo v. Clearinghouse and OCC* (08-453) available at http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/08-453_PetitionerAmCu10ConsumerProtectionOrgs.pdf (last visited 21 June 2009), pages 20-39.

This situation is made worse by the fact that large financial institutions like Countrywide were able to increase their leverage over regulators by taking a significant amount of the agency's budget away when it changed charters and regulators. The OTS and OCC are almost entirely funded through assessments on the institutions they regulate.¹⁹⁴ The ability to charter shop combined with industry funding has created a significant conflict-of-interest that has contributed to the agencies' disinclination to consider upfront regulation of the mortgage and consumer credit markets. Given that it supervises the largest financial institutions in the country, the OCC's funding situation is the most troublesome, according to George Washington University Law School Professor and banking law expert Arthur Wilmarth:

More than 95% of the OCC's budget is financed by assessments paid by national banks, and the twenty biggest national banks account for nearly three-fifths of those assessments. Large, multi-state banks were among the most outspoken supporters of the OCC's preemption regulations and were widely viewed as the primary beneficiaries of those rules. In addition to its preemption regulations, the OCC has frequently filed amicus briefs in federal court cases to support the efforts of national banks to obtain court decisions preempting state laws. The OCC's effort to attract large, multi-state banks to the national system have already paid handsome dividends to the agency....Thus, the OCC has a powerful financial interest in pleasing its largest regulated constituents, and the OCC therefore faces a clear conflict of interest whenever it considers the possibility of taking an enforcement action against a major national bank.¹⁹⁵

In summary, the dynamic created by charter competition encourages regulators to establish regulatory standards that are acceptable to the regulated parties, to block efforts of multiple states to oversee their practices and/or to lower regulatory costs.¹⁹⁶ Such a regulatory environment does not foster the establishment of effective consumer protections.

Regulatory Models for Structural Reform

In assessing proposals to restructure regulation of credit, banking and payment systems that have recently been offered, it is helpful to evaluate the basic structural models that exist for financial regulation. The U.S. system is a complicated, state/ federal variation on the traditional

¹⁹⁴ Plunkett (2009a, p. 54). 100% of the 2009 budget for the OTS is funded by fees and 94% of the 2009 budget for the OCC is funded by fees.

¹⁹⁵ Wilmarth (2007a).

¹⁹⁶ Blair and Kushmeider (2006). "For bankers, charter choice is now generally a question of whether the higher assessment cost associated with a national charter is offset by the benefits of operating under a single set of laws and regulations—the OCC's preemption authority. For banker regulators, charter choice entails working to contain the cost of supervision and finding alternative ways to make charters attractive."

sector-based approach of separate oversight structures for banking, securities and insurance, which still exists in many countries. The U.K. system in place from 2000 to 2010¹⁹⁷ was the most prominent example of unified prudential and business conduct regulation of all three sectors. A variation on unified oversight is an integrated approach, which maintains separate oversight of insurance, banking and securities – combining both prudential and business conduct regulation – but under the direction of an agency designated as the “lead regulator,” or through a collaborative arrangement such as memoranda of understanding.¹⁹⁸ Australia and Canada provide the final major model, “twin peaks” regulation that has separate agencies in charge of prudential and business conduct oversight, usually, but not always, for all three financial sectors.¹⁹⁹ This was the approach chosen by the Treasury Department in 2008 when it recommended a dramatic restructuring of state and federal financial services regulation.²⁰⁰ Many of these countries maintain a separate regulatory apparatus for systemic oversight, sometimes in a separate agency, sometimes at a central bank. Competition and antitrust policy are also typically handled in many countries by different agencies.

Each of these approaches obviously has strengths and weaknesses. Sector-based regulation has the advantage of allowing regulators to develop deep knowledge regarding the financial sectors or institutions they are overseeing.²⁰¹ This expertise, in turn, should result in regulatory decisions that are more effective. A major disadvantage to this approach is, as stated above, that narrow regulatory “silos” can lead regulators to identify too closely with the welfare of the institutions they are overseeing, resulting in regulatory capture and unwise decision-making. Another disadvantage is that this approach can lead to uneven standards for different institutions offering essentially the same products and foster negative competition between regulators. The narrow focus of this type of regulation on one segment of the marketplace also means that regulators do not have a full view of the range of activities pursued by financial conglomerates offering products and services that cut across arbitrary sector barriers.²⁰²

Unified regulation has the potential to eliminate regulatory gaps and uneven standards and to effectively oversee highly complex financial institutions and products. It can also

¹⁹⁷ The recently elected government in the U.K. is dismantling the unified regulatory structure embodied by the Financial Services Authority. George Parker and Brooke Masters, “Osborne Abolishes FSA and Boosts Bank,” *Financial Times*, June 16, 2010.

¹⁹⁸ Wymeersch (2007, p. 24).

¹⁹⁹ Pan (2009, p. 24-27); Cooper (2006).

²⁰⁰ The Department of the Treasury (2008a).

²⁰¹ Pan (2009, p. 19).

²⁰² Pan (2009, p. 19); Wymeersch (2007 p. 21).

eliminate jurisdictional conflict between regulators, increase regulatory accountability and be more efficient and cost-effective. It is also potentially more flexible, allowing regulators to shift staff and resources more easily to address emerging problems that affect different institutions or sectors. However, this flexibility can lead regulators to subjugate one function or set of objectives, such as business conduct oversight, to another sometimes competing function, such as prudential regulation. This can lead to under regulation.²⁰³ Another risk is that the regulator loses deep expertise regarding certain financial sectors and becomes an agency of generalists.²⁰⁴

The twin peaks or functional model allows two different agencies – one prudential regulator and one business conduct regulator – to use different regulatory approaches that are often necessary to achieve their differing regulatory goals. As stated above, prudential regulation often requires regulators to assume a more collaborative, behind-the-scenes approach in helping the financial institutions it oversees remain stable and avoid direct and indirect threats to its financial solidity. Business conduct regulation is, by definition, often more adversarial and requires the regulator to be completely transparent in its rulemaking and enforcement approach. The twin peaks model allows both important regulatory approaches to proceed without subordinating one to the other.²⁰⁵ A hazard to this approach is the potential for conflict between the two agencies regarding the activities and behavior of regulated institutions. Strong business conduct regulation could obviously affect the profitability of a regulated institution, while weak prudential oversight could, for example, lead to the provision of unsustainable credit and be harmful to consumers. “Therefore, the twin peaks model must be accompanied by some mechanism of coordination to resolve conflict that may arise between the regulatory agencies,”²⁰⁶ as one comparative study concluded.

Restructuring Proposals Offered in Congress

In the last two years, many proposals to restructure the federal regulatory apparatus were offered by academics, regulators, interest groups, and lawmakers, but only a few were seriously considered by Congress. Three sets of proposals were the most prominent, each generally

²⁰³ Conservative leaders heading the new government in the United Kingdom severely criticized the performance of the Financial Services Authority for failing to identify and act on causes of the financial crisis and are abolishing it. The government is transferring the FSA's prudential regulatory authority to the central bank and its consumer protection powers to a new consumer protection agency. Parker and Masters (2010).

²⁰⁴ Pan (2009, p. 21); Llewellyn (2006, p. 28).

²⁰⁵ Wymeersch (2007, p. 21).

²⁰⁶ Pan (2009, p. 23). Regarding the need for coordination, see also Llewellyn (2006, p. 25).

tracking one of the major regulatory models mentioned above. The proposal that received the most attention and was eventually enacted would partially replicate the “twin peaks” model to create an independent business conduct regulator (called either the Consumer Financial Protection Agency or the Consumer Financial Protection Bureau), with jurisdiction over all banking, credit and payment system products and services. A second set of proposals would have kept the sector-based, combined prudential-consumer protection regulatory structure as is, but implemented a variety of incremental reforms to elevate the importance of consumer protection regulation. The third set of proposals would have moved towards unified regulation of credit and banking by partially or fully consolidating existing bank regulatory agencies and by requiring greater consumer protection responsibilities.

A Separate Business Conduct Regulator – The Consumer Financial Protection Agency/ Bureau

Legislation to create a Consumer Financial Protection Agency (CFPA) was first proposed by the Obama Administration in June of 2009.²⁰⁷ This legislation was modified and passed by the United States House of Representatives in December of 2009 as part of broad financial regulatory restructuring legislation.²⁰⁸ In the United States Senate, draft restructuring legislation that included the creation of a CFPA was proposed in December of 2009 by the Chairman of the Banking, Housing and Urban Affairs Committee, Christopher Dodd.²⁰⁹ Dodd then altered the proposal to create an independent Consumer Financial Protection Bureau (CFPB) within the Federal Reserve, which passed the Senate in May of 2010.²¹⁰ Final changes to the Senate CFPB proposal were made in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which was signed into law by the President on July 21, 2010.²¹¹

In announcing that it had decided to create an agency to protect financial consumers, the Administration said that it wanted to address all of the major structural causes for the regulatory failures that occurred, including a lack of focus on and accountability for consumer protection; the apparent subordination of consumer protection regulation to prudential regulation at the

²⁰⁷ Department of the Treasury (2008a, p. 55-70). The White House has since offered legislation to effectuate the proposal in this “White Paper.” Legislation is available at <http://www.financialstability.gov/docs/CFPA-Act.pdf>.

²⁰⁸ H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, Title IV..

²⁰⁹ Restoring American Financial Stability Act of 2009, Title X, available at http://banking.senate.gov/public/_files/111609FullBillTextofTheRestoringAmericanFinancialStabilityActof2009.pdf

²¹⁰ S. 3217, Restoring American Financial Stability Act of 2010, Title X.

²¹¹ H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, Title X.

banking agencies; and the conflicts-of-interest and lack of independence at some of the agencies.²¹² The CFPA would resolve these structural flaws, according to the Administration, because it would have “mission focus” on consumer protection, “market-wide coverage” of both banks and non-banks, and “consolidated authority” to write rules, supervise financial entities and enforce its standards.²¹³

Under the Administration’s Consumer Financial Protection Agency Act of 2009 (CFPA Act),²¹⁴ the mandate of the CFPA would be to “promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products or services.” The agency’s four major objectives would be to: provide consumers with the information they need to make responsible financial and credit decisions; protect them from abusive, unfair, deceptive and discriminatory practices; ensure that markets operate fairly and efficiently with room for growth and innovation; and foster access to credit and financial services for underserved consumers.²¹⁵

The mission, objectives, independence and broad powers of the CFPB adopted by Congress are quite similar to those initially proposed for the CFPA by the Administration. Congress did make some significant changes in how the agency will be governed and funded, as well as in its specific rulemaking, enforcement and examination authorities.

Under the Dodd-Frank Act, the CFPB will function as an independent agency within the Federal Reserve System. The Federal Reserve Board is prohibited from intervening in any Bureau policy, funding, organizational or personnel matter. The CFPB will be governed by a single director who is appointed by the President, confirmed by the Senate and can only be removed by the President for cause.²¹⁶ (By contrast, the Administration proposed creating a five-member board to direct the CFPA, with one seat on the board to be held by a prudential regulator.²¹⁷) The director has sole discretion in determining the agency’s annual budget, up to a statutory limit. This funding must be provided by the Federal Reserve Board. If the Bureau director determines that this amount is insufficient, the CFPB is authorized to request appropriations from Congress.²¹⁸

²¹² Department of Treasury (2008a, p. 55-70).

²¹³ Barr (2009, p. 1).

²¹⁴ Available at: <http://www.financialstability.gov/docs/CFPA-Act.pdf>.

²¹⁵ CFPA Act, §1021.

²¹⁶ Dodd-Frank Act, §1011.

²¹⁷ CFPA Act, §1012.

²¹⁸ By 2013, the Federal Reserve will be required to transfer up to 12 percent of its total operating expenses to the CFPB. The director can request an additional \$200 million per year through fiscal year 2014 if he or she determines more funds are necessary. Dodd-Frank Act, §1017.

The Bureau would have jurisdiction over a broad array of transactions related to the sales and marketing of credit, deposit and payment products and services, including: loan brokering and servicing, deposit taking, real estate settlement services, stored value or payment services, check cashing, remittances, debt management and collection and credit reporting. The agency would not have authority over securities and commodities activities regulated by the Securities and Exchange Commission or Commodities Future Trading Commission, or insurance regulated by the states.²¹⁹

The law will transfer to the Bureau from existing agencies most rule-writing, examination and primary enforcement authority for a number of existing fair lending and consumer protection laws related to the products and services over which it has jurisdiction.²²⁰ In writing rules under these existing laws, the agency will be required to weigh the costs and benefits of regulatory action on consumers and industry, including the effect on credit availability.²²¹ The agency will also have rulemaking authority that is independent of consumer protection and fair lending laws regarding unfair, deceptive or abusive acts and practices.²²² In drafting both types of rules, the agency will be required to consult with federal prudential regulators before rules are proposed, regarding the consistency of proposed rules with the policies and objectives of those agencies. To support its rulemaking and other functions, the agency has the authority to collect information from firms for research purposes and will be required to monitor financial risks to consumers.²²³

Because of concerns raised during the Congressional debate that consumer protection actions taken by the Bureau could have a negative effect on prudential oversight of banks, the Financial Stability Oversight Council²²⁴ created by the Dodd-Frank Act has the authority to set aside a final CFPB regulation if the Council determines that the rule “would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk.”²²⁵

²¹⁹ Dodd-Frank Act, §1002.

²²⁰ This would include the Truth in Lending Act (TILA), Truth in Savings Act (TISA), Home Ownership and Equity Protection Act (HOEPA), Real Estate Protection Act (RESPA), Fair Credit Reporting Act (FCRA), Electronic Fund Transfer Act (EFTA), Fair Debt Collection Practices Act (FDCPA), Home Mortgage Disclosure Act, and Equal Credit Opportunity Act. Dodd-Frank Act, §1002.

²²¹ Dodd-Frank Act, §1022.

²²² Dodd-Frank Act, §1031.

²²³ Dodd-Frank Act, §1022.

²²⁴ Dodd-Frank Act, Title I, Subtitle A.

²²⁵ Dodd-Frank Act, §1023. A decision by the Council to set aside a CFPB rule would require agreement by two-thirds of the Council's ten members. Note that a standard that allows the Council to “veto” Bureau rules only if the overall safety of the country's banking or financial system is in doubt is much higher than one that would allow an override if the financial condition of some institutions is affected.

The CFPB will have examination and primary enforcement authority over large banks and credit unions that have more than \$10 billion in assets, but it must coordinate supervisory activities with federal and state bank regulators. The law also sets up a process for allowing a regulated institution to request the resolution of conflicting requirements that may exist between the CFPB and prudential regulators.²²⁶ Because of concerns raised by “community” banks and credit unions that supervision by the CFPB would create an undue enforcement burden, the Bureau has no authority to examine or enforce its rules regarding small to mid-sized banks, thrifts and credit unions.²²⁷ The CFPB is also required to conduct a special assessment of the effect of potential rules on small businesses before it ever proposes the rule publicly,²²⁸ a process that could be quite time consuming.

One of the most significant and difficult tasks that the agency will have is to develop a new “risk-based” federal examination and enforcement regime for non-banks, most of which are currently regulated exclusively at the state level. The Bureau will have jurisdiction to examine and enforce consumer laws and rules regarding most non-banks, including mortgage, payday and private student lenders, as well as non-banks not covered by these categories that the Bureau determines are “larger.”²²⁹

The Dodd-Frank Act includes a number of limitations on the authority of the Bureau, most of which were not proposed by the Administration. The law contains a complicated exemption for some merchants who offer credit²³⁰ because retailers contended that it was not appropriate for the Bureau to regulate credit transactions in which they informally extend small amounts of credit or offer credit for the sole purpose of purchasing non-financial goods or services.²³¹ The law also completely exempts from CFPB oversight the sale of most loans by automobile and other motor vehicle dealers,²³² who claimed that they were already adequately regulated by the FTC and the states.²³³ The law also prohibits the Bureau from imposing usury limits.²³⁴

In a shift from current regulatory policy, the Dodd-Frank Act would not automatically preempt states that enforce stronger consumer protections that are not inconsistent with federal

²²⁶ Dodd-Frank Act, §1025.

²²⁷ Banks, thrifts and credit unions with \$10 billion or less in assets would still be examined by the appropriate prudential regulator. Dodd-Frank Act, §1026.

²²⁸ Dodd-Frank Act, § 1100G.

²²⁹ Dodd-Frank Act, §1024.

²³⁰ Dodd-Frank Act, §1027.

²³¹ Freeman and Wohlschlegel (2009).

²³² Dodd-Frank Act, §1029.

²³³ National Automobile Dealers Association (2009).

²³⁴ Dodd-Frank Act, §1027.

laws or rules against nationally chartered depository institutions or their subsidiaries and affiliates.²³⁵ The law would, however, allow the OCC to determine on a case-by case basis that state laws are preempted if they prevent or significantly interfere with the ability of a national depository institution to engage in the business of banking.²³⁶ State Attorneys General are given authority to enforce CFPB rules against national and state-chartered entities, and to enforce Title X of the Dodd-Frank Act (establishing the CFPB) regarding state institutions.²³⁷

Opposition to the CFPA/ CFPB

Lawmakers, interest groups, academics and regulators have opposed creating an independent business conduct regulator (either as a stand-alone agency like the CFPA or an autonomous bureau as with the CFPB) for a number of reasons. First, many opponents maintain that safety and soundness regulation and consumer protection should not be placed in separate agencies, as proposed in the legislation creating the CFPA and the CFPB. For example, Elizabeth Duke, a member of the Board of Governors of the Federal Reserve System, stated in Congressional testimony, “we view consumer protection as complementary to, rather than in conflict with, other responsibilities at the Federal Reserve, such as prudential supervision and fostering financial stability.”²³⁸ Richard Shelby, a key member of the Senate Banking Committee, also believes that, “a safe and sound banking system is the best consumer protection. For example, a prudently underwritten loan provides protection for both the consumer and the bank that issues it. In order to achieve that goal, the prudential regulator must be responsible for consumer protection.”²³⁹

Other opponents of an autonomous business conduct regulator go further in stating that they think it is necessary and appropriate for regulators to make consumer protection decisions for primarily prudential reasons. For example, Peter Wallison of the American Enterprise Institute testified before the Senate that, “a prudential supervisor, however, might want prepayment penalties to be included in a prudently underwritten mortgage, since the ability of the borrower to prepay at any time without penalty raises the lender’s interest rate risk. It is

²³⁵ CFPA Act, §1041.

²³⁶ H.R. 4173, §4404.

²³⁷ Dodd-Frank Act, §1042.

²³⁸ Duke (2009, p. 1).

²³⁹ Shelby (2009, p. 6).

likely that the bank supervisors and the CFPB will have different policies on this and many other issues and that banks will be caught in the middle.”²⁴⁰

Senator Robert Bennett, who is also a member of the Senate Banking Committee, views combined consumer protection and prudential regulation as a moderating influence on regulators, particularly those who are inclined toward strong consumer protection enforcement. “I’ve served in the executive branch. I know what happens when the culture around a single mission takes over an agency. Republicans say that consumer protection has to be tied to [prudential] regulation so the regulator who’s involved with regulation and consumer protection doesn’t go overboard in one direction or the other.”²⁴¹

Wallison also sees the creation of an autonomous consumer protection regulator as a sharp turn away from the current disclosure-based system of consumer protection, which could limit credit opportunities for consumers, increase the cost of credit and stymie the innovation of new products and features, stating that “...the disclosure system has always seemed appropriate in our society because it does not require invidious or arbitrary discrimination between one person or another. As long as the disclosure is fair and honest, why should anyone be prohibited from buying a product or service?”²⁴²

Shelby has also objected to creating “a massive new bureaucracy to which it [Congress] then delegates a considerable amount of Congressional authority.”²⁴³

Consumer group representatives have responded that much of the discretion and authority granted to the consumer regulator regarding rulemaking, supervision and enforcement is currently held by banking agencies, HUD or the FTC and is merely being consolidated in the CFPB.²⁴⁴ They have also pointed out that, like federal regulators, Congress has acted slowly to curb unfair and deceptive credit practices, and that even when Congress has the will to act, it is virtually impossible to keep up with fast-moving developments in the marketplace. When Congress enacted the FTC Act, it found that “there is no limit to human inventiveness” in designing unfair practices, and that if it tried to pursue these practices itself, “it would undertake an endless task.”²⁴⁵

²⁴⁰Wallison (2009, p. 6).

²⁴¹Grimm (2010).

²⁴²Wallison (2009, p. 4, 5).

²⁴³Shelby (2009, p. 6).

²⁴⁴Calhoun (2009, p. 5). “...for over fifty years, Congress has repeatedly authorized and required federal banking agencies to set and enforce consumer protection standards to prevent unfairness and deception by financial institutions. These delegations do not represent abdication of legislative responsibility; rather, they represent common sense.”

²⁴⁵H.R. Conf. Rep. No. 1142. 63d Cong. 2d Sess. 19(1914).

Opponents of such an agency also support granting federal preemptive authority to the consumer regulator and oppose allowing state policy makers to exceed the standards required by the agency, even if state policy does not conflict with those standards. These opponents raise a number of instances where they believe state laws that go beyond federal laws could undermine the effectiveness of a consumer regulator. For instance, John Dugan, Comptroller of the Currency, raises concerns about the effect of this lack of preemption on national banks, stating, “a core principle of the Proposal is its recognition that consumers benefit from uniform rules. Yet this very principle is expressly undermined by the specific grant of authority to states to adopt different rules; by the repeal of uniform standards for national banks; and by the empowerment of individual states, with their very differing points of view, to enforce federal consumer protection rules – under all federal statutes – in ways that might vary from state to state.”²⁴⁶

A study by Professor Joshua Wright and David Evans concludes that the CFPA Act as proposed by the Administration would have a number of detrimental effects on consumers and the economy, including: reducing access to and increasing the cost of credit; creating a “supernanny” agency that displaces consumer credit choices with its own; threatening the economic recovery; dampening the creation of new businesses and slowing job growth.²⁴⁷ In particular, the study concludes that the creation of a CFPA would increase interest rates paid by consumers by 160 basis points, reduce consumer borrowing by at least 2.1 percent and dampen net creation of new jobs by 4.3 percent.²⁴⁸

In a critique of the study, Professor Adam Levitin concludes that the methodology it uses to make precise determinations about the economic impact of the legislation is deeply flawed. He suggests that it is equally plausible that the CFPA would result in lower costs of credit because it is charged with providing consumers with better information about the total costs of credit products, which could spur vigorous price competition.²⁴⁹

Proposals to Alter the CFPA/ CFPB

Both regulators and industry opponents have offered suggestions to amend proposals to create an independent business conduct regulator. Federal bank regulators have commented on

²⁴⁶ Dugan (2009, p. 12-13).

²⁴⁷ Evans and Wright (2010, p. 2-3).

²⁴⁸ Id, (p. 33).

²⁴⁹ Levitin (2009a, p. 2-3). He points out that the CFPA Act has not been finalized and by itself creates few substantive protections, that Evans and Wright only evaluate potential CFPA costs, not benefits, and that they rely on a single study regarding interstate branching that is not analogous to estimating what impact the CFPA might have on interest rates and job creation.

the need for a greater role for them in the governance and operations of the CFPA. For instance, John Dugan of the OCC stated:

The CFPA rules need to have meaningful input from banking supervisors – both for safety and soundness purposes and because bank supervisors are intimately familiar with bank operations and can help ensure that rules are crafted to be practical and workable. A workable mechanism needs to be specifically provided to incorporate legitimate operational and safety and soundness concerns of the banking agencies into any final rule that would be applicable to insured depository institutions.²⁵⁰

Both the regulators and representatives of industry proposed to change the makeup of the CFPA Board. FDIC Chairman Bair and Comptroller of the Currency Dugan suggested changes to the CFPA’s board as proposed by the Administration to ensure greater representation from other bank regulators.²⁵¹

In addition, Dugan and others²⁵² maintained that the consumer regulator’s work should be limited to overseeing non-bank firms. He contended that the Administration’s proposal “fails to carefully and appropriately target the CFPA’s examination, supervision and enforcement jurisdiction to the tens of thousands of non-depository financial providers that are either unregulated, or very lightly regulated.”

Tweaking the Sector-Based Status Quo

A number of CFPA opponents believed that the CFPA should not be created. Instead, they recommended modest adjustments to the current system to increase consumer protections.

The Consumer Financial Protection Council

The alternative to the CFPA that received the most attention and debate in Congress would create a federal Consumer Financial Protection Council of existing regulators instead of a new agency.²⁵³ The proposal would establish an 11-member council that includes federal bank regulators, HUD, the FTC, and one representative of state regulators.²⁵⁴ Council objectives

²⁵⁰ Dugan (2009, p. 18).

²⁵¹ Id.

²⁵² Yingling (2009, p. 4); Dugan (2009, p. 8).

²⁵³ The proposal, entitled the Consumer Financial Protection Act, was offered as an amendment to H.R. 4173 on December 11, 2009 by Representative Walt Minnick of Idaho and failed by a 208 to 223 vote, available at: http://www.rules.house.gov/111/AmndmentsSubmitted/hr4173/minnick88_hr4173.pdf.

²⁵⁴ Other members include the Securities and Exchange Commission, the Commodities Futures Trading Commission, and the Department of Treasury, §4002.

would include ensuring “meaningful and uniform consumer protection requirements” and functionally equivalent regulation for the same types of financial products.²⁵⁵ The council would be authorized to adopt new consumer protection regulations by a majority vote, but a two-thirds vote is required if it moves to recommend that Congress enact a prohibition of any product or service allowed by law. Any recommendation to Congress to override state law would have to be based on the approval of more than half the states.

The proposal would also require the creation of consumer financial protection divisions in each of these agencies, mandate that the enforcement of consumer protection laws are of equal importance to each agency as the enforcement of other laws, grant UDAP rulemaking authority to eight of the federal agencies on the council, prohibit the extension of mortgage loans that cannot be repaid, permit state Attorneys General to enforce consumer protection rules, and establish a common examination and enforcement process for each of the agencies on the council.

Members of Congress who supported the proposal on the House floor stated that it would elevate the importance of consumer protection regulation by federal agencies without separating consumer and prudential regulation²⁵⁶ or creating an expensive new government bureaucracy.²⁵⁷ Supporters also expressed the view that the Council would not impede access to credit, restrict credit choices²⁵⁸ or limit financial innovation, as the CFPA would.²⁵⁹

Opponents of the proposal responded that it would leave consumer protection authority in the hands of the same regulatory agencies that have failed to protect consumers from questionable lending practices, that it continues to subordinate consumer protection to prudential regulation and that it does nothing to improve oversight of non-banks.²⁶⁰ They also expressed concern that it would create another layer of federal consumer protection oversight without improving decision-making in the fractured system that currently exists.²⁶¹

Increasing the Federal Reserve’s Consumer Protection Authority

²⁵⁵ §4003.

²⁵⁶ Statement of Representative Walt Minnick, U.S. Congress (2009, p. 14772).

²⁵⁷ Statement of Representative Dan Boren, Id, (p. 14772).

²⁵⁸ Statement of Representative Aaron Schock, Id.

²⁵⁹ Statement of Representative Michael Castle, Id. (p. 14773).

²⁶⁰ Statement of Representative Barney Frank, Id. (p. 14773-74).

²⁶¹ Statement of Representative Steny Hoyer, Id, (p.14775).

Leaders of the Federal Reserve responded to criticism of regulatory inaction on a number of issues by acknowledging some regulatory failures in the past, vigorously defending their recent consumer protection efforts, and pressing to keep and expand their consumer protection authority. For example, in testimony last year before the House of Representatives, Federal Reserve Governor Elizabeth Duke stated:

In our view, the Federal Reserve has the resources, the structure and the experience to execute an ongoing comprehensive program for effective consumer protection in financial services. First, we believe that replicating in another agency the deep expertise and full array of functions embedded within the Federal Reserve and used to support our consumer protection program would be enormously challenging.²⁶²

Recent consumer protection initiatives that Federal Reserve leaders have pointed to include a pilot program for supervising non-bank subsidiaries of bank holding companies, final rules regarding unfair and deceptive mortgage and credit card lending,²⁶³ and proposed rules regarding mortgage compensation practices and overdraft loans.²⁶⁴ They proposed expanding the Federal Reserve's consumer protection efforts in three ways, two of which require a Congressional mandate. Federal Reserve leaders and industry representatives called on Congress to codify consumer protection as a core responsibility of the Federal Reserve,²⁶⁵ and to require the Federal Reserve Chairman to report regularly to Congress regarding the "state of consumer protection," as the Chairman currently must do regarding monetary policy. The Federal Reserve also announced that it plans to conduct regular "sufficiency reviews" of consumer protection policies, including current trends in consumer financial services, the adequacy of existing regulations and proposals for improving consumer protection standards.²⁶⁶

Congress did not respond to Federal Reserve proposals to expand its consumer protection mandates. No legislation on these new requirements was introduced or enacted, perhaps because Congress has been immersed in evaluating other, broader measures.

Since some opponents of an independent consumer regulator, like John Dugan, blamed much of today's economic turmoil on non-banks, they suggested granting additional authority to the Federal Reserve to focus exclusively on these firms:

²⁶² Duke (2009, p. 1).

²⁶³ Id.

²⁶⁴ Bernake (2009).

²⁶⁵ Bartlett (2009, p. 5).

²⁶⁶ Duke (2009, p. 17).

One way to address this problem would be to include in legislative language an explicit direction to the Board to actively supervise nonbanking subsidiaries engaged in banking activities in the same way that a banking subsidiary is supervised by the prudential supervisor, with required exams....An alternative approach that may be preferable would be to assign responsibility to the prudential banking supervisor for supervising certain non-bank holding company subsidiaries. In particular, where those subsidiaries are engaged in the same business as is conducted, or could be conducted, by an affiliated bank – mortgage or other consumer lending, for example – the prudential supervisor already has the resources and expertise needed to examine the activity.”²⁶⁷

This proposal and others which focus the agency exclusively on the activities of nonbanks would be an ineffectual solution to the broad regulatory failures at the federal and state level documented in this paper. As stated above, there is considerable evidence that problems with abusive subprime mortgage lending began with non-banks regulated at the state level, but that federal regulators could have stemmed these problems by using their authority to regulate non-bank lenders, by allowing the many states that enacted anti-predatory mortgage lending laws to enforce them against national banks and thrifts and by moving aggressively to properly regulate the large number of subprime and near-prime mortgage loans issued by national lenders. Federal regulators also failed to stop unfair and deceptive credit card and overdraft lending and helped fuel the growth of state regulated payday lending.

Other Proposals to Adjust the Status Quo

A number of industry opponents²⁶⁸ of an independent business conduct regulator have maintained that Congress should enact uniform federal standards that would apply to consumer protections and mortgage disclosures²⁶⁹ to all consumers, “regardless of where they live or what type of institution provides the particular financial product or service.”²⁷⁰

Law Professor Todd Zywicki of George Mason University, and others,²⁷¹ have maintained that the Federal Trade Commission’s jurisdiction should be expanded rather than creating the CFPB. Professor Zywicki states, “instead of creating a new bureaucracy, Congress should instead consider expanding the jurisdiction of the Federal Trade Commission and strengthen the Federal Reserve to meet discrete categories of true consumer protection issues that

²⁶⁷ Dugan (2009, p. 27-28).

²⁶⁸ Courson (2009, p. 4). See also Stinebert (2009, p. 8). Bartlett (2009, p. 10).

²⁶⁹ Bartlett (2009, p. 25). See also Courson (2009, p. 4).

²⁷⁰ *Id.* (p. 10-11).

²⁷¹ Yingling, (2009, p. 16); Stinebert (2009, p. 9).

arise under current law....The FTC has longstanding expertise in consumer financial protection issues as well as related areas of consumer information, labeling and advertising.”²⁷² The ABA has concurred with this assessment. Ed Yingling stated, “the FTC has this authority for non-banks, but there have been severe constraints in using it. Congress should work to give the FTC the capability and funding to apply it to non-banks much more aggressively.”²⁷³

²⁷² Zywicki (2009, p. 34).
²⁷³ Yingling (2009, p. 16).

Unified Prudential and Business Conduct Regulation

Republicans on the House Financial Services Committee developed a regulatory restructuring plan to create a unified banking regulatory agency that merges the OCC and OTS and shifts the supervisory functions of the Federal Reserve and FDIC into one agency. The NCUA would still exist, but as part of the agency. The agency would have centralized supervisory authority of deposit-taking entities while allowing these entities to continue to choose their charter. An Office of Consumer Protection within the agency would consolidate responsibility for rule writing and enforcement of the federal consumer protection laws covering depository institutions, “eliminating the confusion created by the existence of five different Federal Regulatory agencies which currently share consumer protection responsibilities.” Consumer protection rules would be evaluated and updated regularly, based on extensive consumer testing. The office would be charged with authority to improve consumer disclosures so that they are transparent and easy to understand.²⁷⁴ Although this proposal received very little attention in the House of Representatives, a similar plan involving the consolidation of the OCC and OTS and the creation of a consumer unit was considered by senior members of the Senate Banking Committee.²⁷⁵

Conclusion

The refusal of U.S. financial regulators to use their existing authority to protect consumers from unsustainable, unfair and deceptive lending practices, rather than defects in the regulatory structure or gaps in the law, appears to have been the major cause of serious regulatory failures that occurred in the consumer credit markets. However, deep structural flaws in the federal regulatory system – including the delegation of consumer protection authority to regulators who saw prudential regulation as their main priority – appear to have magnified the anti-regulatory bias that existed and encouraged regulators to overlook or ignore their consumer protection mission. Structural deficiencies and conflicts-of-interest also appear to have compromised the independence of banking regulators, created a dynamic in which agencies appeared to compete against each other to weaken standards and ultimately led to a rulemaking process that was cumbersome and ineffectual. These structural weaknesses threatened to

²⁷⁴ Financial Services Committee Republican Plan For Reforming the Financial Regulatory System, p.4. Available at <http://www2.nationalreview.com/dest/2009/06/18/4cf5754c03bf4db4b02aba1a8b5cc6d9.pdf>

²⁷⁵ McGrane (2009).

undermine even the most diligent policies and intentions. They complicated enforcement and vitiated regulatory responsibility to the ultimate detriment of consumers.

The potential effectiveness of the restructuring proposals that were considered and adopted by federal lawmakers must be evaluated on whether they will be effective in addressing the underlying structural causes of significant regulatory failures that occurred in consumer credit markets. First, will these proposals end the existing fractured regulatory structure and put consumer protection at the center of regulatory efforts? Second, will they end the subordination of consumer protection oversight to narrowly defined prudential regulation? Finally, will they ensure a regulatory process that is independent of undue influence by regulated parties?

Based on these criteria, continuing the present sector-based structure without consolidating regulatory authority or broadening it to fully cover non-banks appears to be the least effective option. For example, layering a “Consumer Financial Protection Council” above the existing fractured regulatory regime not only leaves consumer protection in the hands of exactly the same regulators who failed so badly, but also would likely make it more difficult and time consuming for them to act. In fact, the Council proposal creates a broader and more cumbersome decision-making process without resolving any of the root causes that led to regulatory failures. Likewise, proposals to simply have Congress enact laws to address the lending problems cited above do not address any of these structural problems at the regulatory level and are not realistic. Congress has delegated broad regulatory authority regarding unfair and deceptive practices to these agencies for decades precisely because a large legislative body cannot stay abreast of fast-moving developments in the marketplace. Moreover, the Congressional consensus right now has clearly shifted sharply towards a desire for fast-moving action by regulators to address unfair and deceptive practices and sharply away from a laissez faire dependence on disclosure-based consumer protection laws and regulations.

Creating a more unified regulatory structure that covers both prudential and consumer protection regulation could address one major cause of the regulatory failures that occurred: the conflicts-of-interest and “charter-shopping” that undermined the regulatory independence of the OCC and OTS. By consolidating the regulatory structure and establishing a single office of consumer protection within this regulatory agency, it will eliminate the ability of financial institutions to move with their large assessments to a more accommodating agency. However, it is not at all certain whether such consolidation would ensure that consumer protection is a

priority for federal regulators. Simply having an office of consumer protection within a unified regulatory agency does not put the issue at the center of the agency's agenda, or ensure that the agency will allocate significant resources to consumer protection, or prevent consumer protection from, once again, being subordinated to prudential oversight. In fact, if such a proposal led to the creation of a larger, more powerful version of the OCC, it could exacerbate the subordination problem over time and further diminish the importance of consumer protection regulation. Nothing in such a proposal would prevent a unified prudential-consumer regulator, for example, from using specious prudential reason to block or eviscerate consumer protection measures, as the Comptroller of the Currency attempted to do regarding proposed credit card regulations. Finally, the unification proposal does not expand federal regulatory and supervisory authority to cover non-banks.

Proposals to broaden the authority of either the Federal Reserve or the Federal Trade Commission have the potential to address some consumer protection concerns. The Federal Reserve has moved away in the last two years from the ideological bias it showed against substantive consumer protection regulation. It has established a positive recent track record on credit card and mortgage lending rules, it is beginning to supervise non-bank holding company subsidiaries, and it has urged Congress to require it to meet a statutory consumer protection mandate. However, providing the Federal Reserve with an enhanced consumer mandate would not unify the divided regulatory regime or address regulatory independence problems at the OCC and OTS. This enhanced authority also would not ensure that once the current economic and housing crises pass, consumer protection oversight would continue to be a priority for the Federal Reserve, given the agency's monetary and systemic risk missions, its broad macroeconomic focus discussed at length above, and its historic unwillingness to devote significant resources to examining "anecdotal" consumer protection problems that develop throughout the country.

The Federal Trade Commission is an independent agency focused on consumer protection, but it has been statutorily limited to non-prudential oversight of non-banks. To date, Congress has shown little interest in expanding that mandate. The FTC's potential ability to pursue an independent consumer protection course would not be in question. However, the agency has antitrust and consumer protection responsibilities for large sectors of the economy. It could not perform the enormous new task of overseeing the entire financial services industry

without significant, dedicated new sources of funding that do not compromise its ability to act independently, such as “non-negotiable” assessments on regulated institutions and firms.

The legislative proposal that has by far the most potential to ensure effective consumer protection, but is not without risk, is the structure Congress has chosen to create: an independent business conduct regulator like the Consumer Financial Protection Bureau. This new bureau is designed to address all three underlying causes of the structural problems that occurred and provide the Bureau with the authority to regulate both depository and non-depository institutions. An autonomous bureau will establish that consumer protection is a clear priority for the federal government and will allow Congress, the public and regulated entities to hold the agency accountable for its decisions and actions. The bureau will focus solely on consumer protection goals and not face the possibility of being subordinated to a narrow view of prudential regulation that is focused primarily on the profitability of regulated institutions. By having consolidated regulatory authority for all credit and payment system products and services, the bureau will not face pressure to weaken regulatory standards because an institution it oversees might move to another regulator.

As mentioned above, however, the potential for conflict is significant between the prudential agency (or agencies) and the business conduct regulator in such a system. Prudential and business conduct regulators ultimately have different goals, use different methods and have different regulatory cultures. As required in the new law, the two regulators will need to collaborate formally and informally on rulemaking and supervision. Moreover, a process will be in place to resolve conflicting decisions as they affect regulated entities. Prudential regulators will be able to offer substantial input to the CFPB, but they will not control the decision-making process at the Bureau. It was control over decisions about consumer protection, after all, that led to serious regulatory failures in the consumer credit markets.

Recent history has demonstrated that even an agency with an undiluted mission to protect consumers can be undermined by hostile or negligent leadership or by Congressional intervention on behalf of special interests. However, unless the structure of financial services regulation is realigned to change not just the focus of regulation but its underlying philosophy, it is unlikely that consumers will be adequately protected from unwise or unfair credit products in the future. The creation of an independent, fully empowered business conduct regulator like the CFPB will help ensure that an important priority of federal financial regulation is to protect consumers, that agency

decision-making is truly independent, and that agencies do not have financial or regulatory incentives to keep standards weaker than necessary. Such a systemic realignment of the financial regulatory structure offers the best opportunity to prevent a repetition of past failures and to establish more effective oversight of consumer credit in the future.

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