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## Singularity of Purpose: Is Looking Out for Consumers Too Narrow a Mission?

No one doubts that consumers have been hurt by the global financial crisis and a better federal and state regulatory regime could lessen the likelihood of future harm in the consumer credit arena. The question is how best to accomplish that objective? Is it simply a matter of better funding of the enforcement of existing laws? Is it prudent to impose new substantive obligations on providers of consumer financial products and services? Do we need to shuffle the boxes out of which regulators operate to ensure a better-coordinated approach to government regulation and enforcement?

At a press conference on June 17, 2009, President Obama laid much of the blame for the financial crisis on gaps in financial regulation. To fill in those gaps, the President unveiled his proposed financial regulatory reform package—a white paper entitled *A New Foundation: Rebuilding Financial Supervision and Regulation*. Among many recommendations for significant change,<sup>1</sup> the reform package recommends the creation of a new federal agency with the singular job of, in the words of Mr. Obama, “looking out for consumers.” The new Consumer Financial Protection Agency (CFPA) would be designed to protect consumers in the financial products and services markets, and would be the primary federal consumer protection supervisor.

What is missing from this proposal, however, is anything more than a cursory attempt<sup>2</sup> to balance the competing, legitimate interests of consumers and industry. Existing federal banking agencies, for example, constantly are balancing safety and soundness issues pertaining to the regulated financial institutions with efforts to protect consumers. If the safety and soundness vista is irrelevant to the regulatory process, how likely is it that new regulations will blanket consumers with excessive levels of protection but without regard to the unintended consequence of potentially limiting the availability of responsible, affordable consumer credit? So, while “looking out for industry” is not a popular phrase in Washington, D.C. these days, the end result of solely looking out for consumers might well backfire.

One of the main purposes behind the creation of the CFPA is to eliminate regulator shopping. A federally-supervised institution would not be able to select its regulator based on which entity will be the least restrictive, because under the plan, the CFPA would have broad authority to regulate all financial products and services providers, with the limited exception of those investment products and services that the Securities and Exchange Commission (SEC) or Commodity Futures Trading Commission (CFTC) already regulates.

Another reason that the Administration cites in favor of this single-agency approach to regulation is that a single agency would ostensibly be able to act more quickly than the federal banking agencies have been able to act as a group. As an example, the white paper points out that the federal banking agencies did not propose supervisory guidance on subprime and nontraditional mortgages until December 2005 and did not finalize the guidance until June 2007, while most of these types of

mortgages were originated in 2005 and 2006. It may be true that one agency acting alone could propose and finalize new regulations and guidance more quickly than the federal financial regulatory agencies could as a group. However, given the incredibly broad range of laws and entities that would come under the CFPA's purview as proposed, and the myriad responsibilities with which it would be tasked, the CFPA would have to be one mammoth agency.

### **Creation of a Consumer Financial Protection Agency**

The agency that is envisioned in the Administration's proposal goes well beyond the "Financial Products Safety Commission" that Congress proposed in legislation introduced earlier this year, which we reported on in our alert *Fifty Ways to Need a Lawyer*.<sup>3</sup> Under that bill, a commission would be established to focus on protecting consumers from risky financial products and services. But the bill did not propose shifting any enforcement or supervisory authority away from any other federal agency. The Administration's proposal, on the other hand, would usurp some of the powers of other federal agencies and give exceptionally broad authority to the CFPA. The CFPA's powers would be virtually boundless when it comes to entities that offer financial products or services, and the potential pitfalls for such entities trying to comply with the foreseeable increase in regulations would be numerous.

#### **Jurisdiction and Structure of the CFPA**

The CFPA would have broad jurisdiction over consumer financial products and services such as credit, savings, prepaid cards, and other payment products and related services. It would have supervisory, examination, and enforcement authority over the institutions that issue, provide, or service these products, as well as those that provide services to the entities that provide the financial products. The CFPA would have a Director and a Board, including at least one seat reserved for the head of a prudential regulator.<sup>4</sup>

The proposal envisions that the CFPA would take a leading role in financial education and the promotion of community development investment. To carry out its obligations as outlined in the proposal, the

agency would need quite a large staff, expressly including but not by any means limited to a research and statistics department, a fair lending unit, and a group of examiners specifically trained and certified in community development.

#### **Rulemaking Authority**

The Administration's plan would give the CFPA sole authority to promulgate and interpret regulations under existing consumer financial services and fair lending statutes, and any future consumer protection laws addressing consumer credit, savings, collection, or payment markets. Laws falling under the umbrella of the agency's authority would include (but not be limited to) the Truth in Lending Act (TILA), Home Ownership and Equity Protection Act (HOEPA), Real Estate Settlement Procedures Act (RESPA), Community Reinvestment Act (CRA), Equal Credit Opportunity Act (ECOA), Home Mortgage Disclosure Act (HMDA), and Fair Debt Collection Practices Act (FDCPA). Moreover, the agency also would have the authority to adopt rules against unfairness, abuse, or deception, which could apply to any entity engaging in providing a covered financial product or service, including intermediaries such as mortgage brokers and debt buyers. These changes in regulatory authority would represent a seismic shift from the current system, which the Administration views as "fragmented." If adopted, the plan would confer an enormous amount of power to a single regulator. However, some institutions may benefit from only having to consider one entity's regulatory interpretations when developing compliance plans. Under the current system, affiliated entities with multiple regulators often have to manage to different standards, making compliance complicated and costly.

#### **Regulatory Reviews and Advisory Council**

To assess the effectiveness of regulations, the CFPA would be required to perform a regulatory review of each newly enacted regulation at least every three years after the effective date. The reviews should include mandatory assessments of the adequacy of consumer disclosures. An outside advisory council comprised of persons with deep experience in financial services and community development would promote accountability and would assist the

CFPA by providing information on emerging industry practices. The council would also facilitate coordinating with other agencies such as the SEC and CFTC to promote consistency and gap-free coverage of financial products and services.

### **Supervisory and Enforcement Authority**

Under the plan, the CFPA would have extensive authority over all entities that are subject to its regulations. The agency would assume from the federal prudential regulators all responsibilities for supervising banking institutions for compliance with consumer regulations. Its jurisdiction would extend to bank subsidiaries, as well as bank affiliates that are not currently supervised by a federal regulator. The CFPA also would have supervisory authority and “the full range of enforcement powers” over non-banking institutions within its jurisdiction, although the plan indicates that “states should be the first line of defense” for such entities. If a state brings an action for a violation of a CFPA regulation, the CFPA would have the ability to intervene.

The CFPA would have subpoena authority, which it could ask the U.S. Attorney General to enforce on its behalf. The agency would be expected to work closely with the Department of Justice, which would have independent authority to enforce violations of the statutes administered by the CFPA.

### **State Authority**

Under the plan, states would retain their authority to adopt stricter consumer protection and fair lending laws, and would have concurrent authority with the CFPA to enforce CFPA regulations. The plan also proposes a sharp retrenchment of federal preemption for federally-chartered institutions (*i.e.*, national banks and federal savings associations) and their operating subsidiaries. Under current law, states have virtually no authority to apply their consumer protection laws to those institutions. The plan proposes that federally-chartered institutions be subject to “nondiscriminatory state consumer protection and civil rights laws” to the same extent as other institutions. States also would be given the authority to enforce their consumer protection and civil rights laws as well as the CFPA regulations with respect to federally-chartered institutions. The current rule, according to courts that have

considered the issue, is that states may not enforce their laws (even laws that are not preempted) against federally-regulated institutions, except in a few discrete areas specifically provided for in federal law. (This rule’s application to state laws that are not preempted is the subject of a Supreme Court case<sup>5</sup> that should be decided by the end of June; even if the Court holds that states have the authority to enforce non-preempted laws against these institutions, the plan’s vision of state authority would still substantially change the supervisory regime for federally-regulated institutions, as most consumer protection laws currently are preempted for those institutions—limiting the effect of a state victory in the Supreme Court case.)

The CFPA would be the primary federal compliance supervisor of state banks supervised by a federal prudential regulator.

The ultimate result of the plan would be that both federally- and state-chartered entities would be subject to regulation and enforcement by the CFPA *and* all 50 states. This represents an enormous change to the current regulatory structure and would drastically increase the compliance burden and enforcement exposure for most institutions.

### **Administration of Licensing and Registration Regimes**

The plan contemplates a great deal of coordination with state regulators, and the CFPA would be responsible for helping the states unify and strengthen their standards for licensing and registration. The Administration suggests that the CFPA should administer the SAFE Act,<sup>6</sup> and establish or facilitate registration and licensing regimes for other financial services providers and intermediaries, such as debt collectors, debt counselors, or mortgage modification entities. Currently, the federal banking agencies and the Department of Housing and Urban Development have the authority to administer the SAFE Act for those institutions that originate mortgages. Shifting that authority from the federal agencies to the CFPA would mean a more consolidated approach to the implementation of the SAFE Act, and a better chance for uniformity of the obligations of a licensee or registrant. On the other hand, the requirements may be more onerous across the board as a result. For example, one suggestion that the

plan mentions is that the CFPA should be allowed to set higher minimum net worth requirements for originators.

### **Consumer Complaints**

While states would retain primary responsibility for tracking consumer complaints about non-federally-supervised institutions, the CFPA would be responsible for collecting and tracking, and facilitating resolution of, consumer complaints regarding federally-supervised institutions.

### **Arbitration Clauses**

The proposal would have the CFPA study mandatory arbitration clauses in consumer financial services and products contracts to determine whether and how they promote fair adjudication and effective redress.

### **Transfer of FTC Authority**

The plan would divest the Federal Trade Commission (FTC) of some of its authority and give it to the CFPA. For example, the Administration recommends that the FTC's primary authority for financial product and services protections be transferred to the CFPA, leaving the FTC with "backup authority." The FTC would continue to be the lead federal consumer protection agency on data security issues, but the CFPA would take authority for front-end privacy protection issues.

The FTC would have authority to make rules for unfair and deceptive practices and obtain civil penalties, although it is unclear how this authority would mesh with the CFPA's authority to do the same. Fraud in the financial marketplace would remain under the FTC's purview, but the CFPA would also have the authority to deal with fraud.

In general, the plan seems to envision that the CFPA would coordinate its efforts with other agencies to enforce violations of consumer protection laws. In the case of nonbanking institutions, the CFPA would be given the full range of supervisory and enforcement powers, with the states as the first line of defense.

## **Series of Recommendations for the Reform of Consumer Protection**

Beyond the above outline of the CFPA's authority and responsibilities, the plan goes on to address four main principles for reforming consumer protection, including: (i) transparency; (ii) simplicity; (iii) fairness; and (iv) access.

### **Transparency**

The plan proposes that disclosure forms be made clear, simple, and concise, and suggests that the CFPA should be authorized to establish standards and procedures for providers to conduct field tests of disclosures. Having authority over TILA and RESPA, the CFPA should be responsible for developing and testing a single, integrated federal mortgage disclosure that covers both RESPA and TILA disclosures. There is no real discussion of how this would work except for a comment that this authority should not delay or affect current efforts to achieve a single federal disclosure.

The plan also proposes that the CFPA be authorized to require that communications with consumers are "reasonable" rather than merely technically compliant and non-deceptive. "Reasonableness" includes a balanced presentation of risks and benefits, and clarity and conspicuousness in the description of significant product costs and risks. The CFPA could impose this duty of reasonableness on service providers and intermediaries and would take administrative action if communications, including marketing materials, violate this duty. Of course, a reasonableness standard is the type of vague standard that makes providers nervous because it is so subjective.

When creating new products, providers would be required to update mandatory disclosures. The provider could petition the CFPA for a "no action" type of determination that its model disclosure or marketing materials adequately disclose the product's risks. The plan envisions that if the CFPA fails to respond in a timely fashion, the provider could proceed to market the product without fear of administrative sanction on that basis. However, there would probably be a mandatory waiting period, which the provider could shorten by demonstrating that the disclosure adequately discloses relevant risks. It is difficult to imagine

this new product disclosure review process as a seamless one given the multitude of other responsibilities of the new agency, the mass of entities that the agency would oversee, and the large number of new products and marketing materials that providers of financial products and services regularly create. This process of requesting approval of disclosures of new products would likely be a slow one and would stunt the growth of new and different financial products; but that is perhaps a result that fits in with the overall proposal, which clearly disfavors complex mortgage products in favor of simple, straightforward products.

Another suggestion for ensuring that disclosures are more transparent for the consumer relates to the use of technology. The plan suggests, among other things, that the CFPA should mandate or encourage calculator disclosures for mortgages to assist consumers with comparison shopping.

### **Simplicity**

“Plain vanilla” mortgage products are strongly favored under the plan for their simplicity and lower risk compared to other products. Plain vanilla products would include those that are underwritten to document income fully, collect escrow for taxes and insurance, have predictable payments, and which do not include prepayment penalties. The proposal suggests that the CFPA could actually require companies to offer such plain vanilla products alongside its other lawful products, and could require a warning label on alternative products. Originators and purchasers of products that do not fit into the plain vanilla category would be subject to “significantly higher penalties” for violations of the CFPA’s consumer protections. Obviously, the objective behind these provisions is to protect consumers against the ills associated with exotic products such as option ARM and negative amortization ARM loans. The potential downside, of course, is that the regulatory disincentives for deviating from plain vanilla products could hinder potentially beneficial product innovations.

The CFPA also could require providers to have applicants fill out financial experience questionnaires or require providers to obtain written opt-in from the applicant for such alternative products. It is not clear whether a provider would be able to rely on such questionnaires and opt-in forms

as a defense to a claim that a consumer did not understand the product risks.

### **Fairness**

As previously mentioned, the proposal recommends that the CFPA assume the statutory authorities to regulate unfair, deceptive, and abusive acts or practices for all credit, savings, and payment products. The Administration suggests that the CFPA would also have the authority to address overly complex financial contracts and with that authority it could consider whether to strengthen mortgage regulations by banning prepayment penalties and yield spread premiums or overages, either entirely or for certain types of loans. The CFPA could also consider regulating loan originator compensation by tying compensation to loan performance over time.

To address problems with conflicts of interest, the CFPA would have the authority to impose duties of care on financial intermediaries such as mortgage brokers and debt counselors. For example, the agency could impose on mortgage brokers a duty of best execution with respect to available mortgage loans, and a duty to determine whether a borrower can afford a loan.

Finally, the proposal imagines consistent regulatory treatment for similar products to make it easier for consumers to make informed choices.

### **Access**

Enforcement of the CRA would be a core function of the CFPA; indeed, the CFPA would have sole authority to evaluate institutions under the CRA. The proposal alleges that CRA enforcement weakened in recent years and needs to be bolstered. More robust application of the CRA, the Administration submits, would promote access to credit. In a similar vein, the plan suggests that vigorous enforcement of fair lending laws also promotes access to credit. As the agency would be tasked with fair lending enforcement, it should maintain a fair lending unit with attorneys, compliance specialists, economists, and statisticians. Collecting new fields as part of HMDA data will aid the CFPA in fair lending enforcement. In particular, according to the proposal, the following new fields should be added to HMDA data: a universal loan identifier that

permits tying HMDA data to property databases and proprietary loan performance databases, a flag for loans originated by mortgage brokers, and information about the interest rate type.

### Conclusion

If the Consumer Financial Protection Agency were to be established as envisioned in Mr. Obama's

financial regulatory reform package, it would have far-reaching effects on the financial services industry. It remains to be seen how many of these recommendations will have the support of Congress and actually make their way into legislation, but in the current environment, there is a great deal of support for major change. We will continue to monitor and report on developments in this area.

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<sup>1</sup> Our firm is preparing separate alerts covering other portions of the proposal.

<sup>2</sup> The proposal requires the CFPB to consider the costs to consumers of existing or new regulations, including any potential reduction in consumers' access to financial services.

<sup>3</sup> See Melanie Brody & Stephanie Robinson, *Fifty Ways to Need a Lawyer: Congress Proposes to Establish Financial Services Watchdog Agency*, April 2009, available at [www.klgates.com](http://www.klgates.com).

<sup>4</sup> The white paper frequently uses the term "prudential regulator," but does not expressly define it.

<sup>5</sup> *Cuomo v. Clearing House Ass'n, L.L.C.*, 510 F.3d 105 (2d Cir. 2007), cert. granted, 77 U.S.L.W. 3412 (U.S. Jan. 16, 2009) (No. 08-483).

<sup>6</sup> The SAFE Act is the more commonly known name for the Secure and Fair Enforcement for Mortgage Licensing Act of 2008.

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