

Considering a Financial Product Safety Commission

In 2007, Elizabeth Warren proposed the creation of a Financial Product Safety Commission (FPSC)—an independent commission that would have the power to monitor financial services much as the Consumer Product Safety Commission monitors consumer products. After sharing a working paper with a research group at the Tobin Project, Warren argued in the 2007 *Democracy: A Journal of Ideas* article publicly surfacing the idea (“Unsafe at Any Rate”) that such a commission would critically improve consumer protections and ultimately help create a more competitive market:

“Consumers can enter the market to buy physical products confident that they won’t be tricked into buying exploding toasters and other unreasonably dangerous products. They can concentrate their shopping efforts in other directions, helping to drive a competitive market that keeps costs low and encourages innovation in convenience, durability, and style. Consumers entering the market to buy financial products should enjoy the same protection. Just as the Consumer Product Safety Commission (CPSC) protects buyers of goods and supports a competitive market, we need the same for consumers of financial products—a new regulatory regime, and even a new regulatory body, to protect consumers who use credit cards, home mortgages, car loans, and a host of other products.”

In March of 2009, bills proposing the creation of the FPSC were introduced in both the Senate and the House. As debate continues among advocacy groups, other policymakers, and prominent scholars, we asked five experts in varying disciplines to respond to the FPSC proposal. Their thoughts and suggestions follow.

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The Credit Cure

Regulatory authority for financial products is weak and fractured. Existing agencies are focused on missions that are either tangential or counter to consumer protection. At the federal level, a myriad of agencies has at least a modicum of control over financial products. At the state and local level, regulators have dwindling authority due to pre-emption turf battles with federal agencies. Even the mightiest regulator, the Federal Reserve Board, has limited authority because it cannot regulate non-bank lenders. Further, its duty to ensure the stability and profitability of the banking system distracts or even deters it from a consumer protection mission. A single agency with a single focus would better protect consumers from financial harm.

On the above points, I completely agree with Oren Bar-Gill and Elizabeth Warren’s article, *Making Credit Safer*.¹ I find their choice of a model for a new financial regulator, however, a bit puzzling. Bar-Gill and Warren advocate for a Financial Product Safety Commission, building off the existing Consumer Product Safety Commission that regulates tangible goods such as toys and electronics. That agency largely uses a binary approach, either banning or approving products, without promulgating guidelines for their use. I contend that a more apt analogy for financial product regulator is to the Food and Drug Administration (FDA). Pharmaceuticals, like credit products, are not easy to categorize as safe or dangerous on an across-the-board basis. The task is to calibrate the product to the consumer and to balance the benefits of use against the risks. The FDA has to contend with the hard reality that some people are willing to suffer grave side effects to cure grave diseases, just as some people are willing to suffer severe financial distress to relieve severe privations. The most difficult challenge of consumer credit regulation is not to deem products *per se* safe for use but to proscribe in detail the way in which they can be used safely.

Making Credit Safer argues for “parity of treatment between ordinary physical products and financial products.”² Using an exploding toaster as their paradigmatic example leads the authors to the Consumer Product Safety Commission as its structural model for a financial regulator. Yet, as Ronald Mann has noted, the analogy between financial products and toasters is problematic.³ He explains that the difficulty lies with “operationalizing the concept of safety” and explores ideas about what safety should mean for financial product regulation.⁴ As a normative matter, we may believe that people should be permitted to inflict financial harm on themselves but not the physical harms that can occur with tangible goods. A burned arm from a toaster may be categorically unacceptable in a way that a bankruptcy from an auto title loan is not. This willingness may stem at least in part from a lack of knowledge about the household-level consequences of dangerous financial products.⁵ There are no emergency room reports of missing toes or statistics on crashed all-terrain vehicles to measure the damage of financial products.

I believe financial distress causes real harms. However, they are undoubtedly less tangible, less visible, and less studied.⁶ The suffering that accompanies financial distress is private. The level of harm may also vary dramatically depending on the individual’s threshold for stress, their resources for coping with financial distress, and the depth of the social safety net. When a toaster explodes, we can agree on the nature of the harm—an electrical fire. By analogy, when a homeowner cannot afford an adjustable-rate mortgage, the nature of the harm defies consistent description. Some families may lose their home or even become temporarily homeless; others may cope by having one household member get a second job to earn extra income. I would define the former harm as severe, suggesting the product should be banned. The latter harm, however, seems to be successfully

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

2 *Id.* at 6.

3 Ronald J. Mann, *Unsafe at Any Price?*, PENNUMBRA 167, available at <http://www.pennumbra.com/responses/02-2009/Mann.pdf> (2009).

4 *Id.*

5 At this moment of the mortgage meltdown, we clearly have a sharp understanding of the macroeconomic harms of dangerous financial products.

6 Ronald J. Mann, *Charging Ahead: The Growth And Regulation Of Payment Card Markets* 185–187 (2006); John A.E. Pottow, *Private Liability For Reckless Consumer Lending*, 2007 U. Ill. L. Rev. 405, 416–418 (2007).

mitigated. We would not similarly suggest that one could appropriately mitigate the electrical fire from the toaster with a fire extinguisher. The visibility and consistency of the harm from tangible goods lead directly to a shared consensus about the remedy. Without robust data on the nature and extent of the harms from financial products, I suspect that regulators would not be comfortable with the level of paternalism inherent in the Consumer Product Safety Commission's remedies for goods.

The Consumer Product Safety Commission uses the following strategies to address unsafe goods: ban a product that is entirely unsafe, recall a defective product for repair or redesign, mandate product quality standards, or work with industry to develop voluntary standards. As a general matter, one can easily imagine the application of these tools to financial products. If 2/28 adjustable-rate mortgages are found to be "defective," the equivalent of a "recall" is a modification to rewrite the loan into a fixed-rate loan. We already have a few quality standards for credit products, such as required disclosures that must be sold with the products.⁷ Rarely, we have even seen voluntary industry standards such as Citibank's announcement that it would eliminate universal default in response to regulator's questions about the propriety of the practice.⁸

Notably, the Consumer Product Safety Commission does not test or certify products as safe. Its approach contrasts with the FDA, whose testing procedures are designed to prevent harm as an ex ante matter. Only when the drug testing process goes awry does the FDA have to clean up the harm with a ban or recall. The FDA's proactive, front-end approach focuses on documenting a product's effectiveness and side-effects and prescribing use regulations. Given the complexity of potential harm from financial products, the regulatory process of the FDA for

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pharmaceuticals is a useful parallel. In the remainder of this piece, I describe three aspects of FDA practice that a financial regulator should adopt. Appropriate safety standards for financial products will require implementing clinical trials, addressing the practice of off-label use, and a sharp disclosure scheme that mimics the force of the black box warning on drugs.

As Bar-Gill and Warren demonstrate in their proposal, today's financial products operate in complex ways on human behavioral traits. Credit cards are not exploding toasters that can be objectively probed in a laboratory. It is insufficient for a regulator to review the disclosed product terms and on that bare

basis to find that a product is not unfair or deceptive. Regulators need robust use-pattern data.⁹ Drawing on the FDA model, creditors should be required to conduct clinical trials of credit products and share their findings with the regulating agency. The credit industry already gathers such detailed use-pattern information, which permits it to refine its products and inhibit consumer learning.¹⁰ Countering that informational advantage by requiring the industry to disclose its use data to a federal regulator would limit exploitation of consumers' imperfect information about the effects of a particular credit product. We would not condone a pharmaceutical company withholding information from the government on the risks of a drug. The same rule should apply to credit products.

The clinical trials for credit products would replicate the benefits of pre-market drug testing. The regulator would draw on these data to establish recommended standards for safe product use. For example, a loan or credit card might not be recommended for long-term use or might be contraindicated for elderly consumers. These are dosage equivalents for credit products.¹¹ The focus would be not just on providing directions that set out the

7 See e.g. 15 U.S.C. § 1663 (stating that a credit advertisement may not state a specific payment amount can be arranged or a specific down payment is required, unless creditor usually arranges such payments).

8 Credit Cardholders' Bill of Rights: Providing New Protections for Consumers: Hearing on H.R. 5244 Before the Subcomm. on Fin. Inst. and Consumer Credit of the Comm. on Fin. Services, 110th Cong. 61 (April 17, 2008) (statement of John Carey, Chief Administrative Officer and Executive Vice-President of Citigroup).

9 The Federal Reserve Board recently took a step in this direction by testing Truth-in-Lending disclosures on actual consumers and incorporating that feedback into its new Regulation Z rules for disclosures. Truth In Lending, 70 Fed. Reg. 60237 (October 17, 2005).

10 Credit Cardholders' Bill of Rights: Providing New Protections for Consumers: Hearing on H.R. 5244 Before the Subcomm. on Fin. Inst. and Consumer Credit of the Comm. on Fin. Services, 110th Cong. 92-100 (March 13, 2008) (statement of Gregory Baer, Deputy General Counsel, Bank of America).

11 parallel idea is embodied in the concept of suitability. In the United States, we apply such a standard to the brokering of financial products, requiring that financial advisors refrain from selling products to people whose financial situations or sophistication are not well-matched to the product's use and risks. NASD Rule 2310. Academics have proposed imposing a similar duty on purveyors of mortgage loans. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1318-1321 (May 2002). The European Union has debated suitability for credit products. Proposal for a Directive of the European Parliament and of the Council on the Harmonization of the Law, Regulations and Administrative Provisions of the Member States Concerning Credit for Consumers," at Art. 6.3, COM (2002) 443 final (Sept. 11, 2002).

appropriate use of the product but also on measuring the ease of overdose and the harm from misuse. Clinical trial outcomes would establish the side effects and their frequency. Consumers may reconsider a payday loan if they knew the odds that they would become trapped in a cycle of payday debt.¹² Alternatively, a regulator could ban a product term such as an over-the-limit fee until industry came up with a disclosure or technological innovation that reduced the rate of overdraft on credit cards. The regulatory agency would establish clinical trial protocols that could include small- and large-scale studies, examinations of the products effects on vulnerable populations, and mandatory post marketing reporting to monitor shifting product use. Clinical trials of this nature would likely have captured the high foreclosure rate of subprime ARM loans and led regulators to issue prohibitions that were both earlier and stronger than the eventual interagency guidance that cautioned against nontraditional mortgages.

The drug-approval process offers another important lesson for financial regulators on the difficulty of understanding product use. Once an FDA approves a drug, a physician may prescribe it legally for any medical condition, even one that was not examined in a clinical trial. The practice of off-label use is controversial but would surely plague the market for credit products. Framing the problem in terms of off-label use forces the confrontation of a critical question: what is the appropriate use of a high-cost financial product? We might think that it is inappropriate to use a payday loan to obtain funds for gambling but appropriate to borrow from a payday lender to pay a plumber when pipes unexpectedly burst. Similarly, credit cards may be safe and cheap devices for payment and spending but harmful tools for borrowing.¹³ The product encompasses both features, and consumers choose the appropriate amount of each activity. In the current regulatory environment, regulators give consumers no direction on credit product use.

A financial regulator cannot ignore the difficulty in constraining how consumers will use the product. Even “safe” credit products

with relatively clear disclosures and lower costs can result in financial ruin if the funds are misused. Sophisticated regulation would identify ways to encourage compliance with the recommended use of the product. In the drug context, pharmacists may only pass out a limited supply of pills at one time, forcing a repeat visit to the pharmacy that is designed to prevent overdose. Similarly, we could constrain repeat borrowing. Some states have attempted such restrictions by prohibiting the rollover of pay day loans.¹⁴ This rule may reduce financial distress by forcing consumers to do the additional work of locating a different pay day loan company to borrow again. Returning to the credit card context, a regulator should be concerned with the rate at which consumers pay down balances. Requiring that consumers change their use preference by mandating higher minimum payments could reduce the incidence of financial distress attendant to credit card use.¹⁵

To push people toward using the credit product for its intended purpose, a credit regulator could identify the financial situation that the credit product could alleviate. The parallel is to the FDA’s specification that drug manufacturers identify the diseases for which a drug is beneficial. People who used a product for a different purpose, those who engage in “off-label” use, could be denied some debtor protections such as the ability to discharge the loan in bankruptcy. Alternatively, creditors who “prescribe” inappropriate products for debtors could be denied legal rights to collect such debts. Just as health insurance may not cover experimental drug treatments, perhaps we should not collectively bear the costs of protecting debtors or aiding creditors who have exceeded the bounds of appropriate credit use.¹⁶

A final provocative parallel to the regulation of pharmaceuticals is the FDA’s system of “black box” warnings. The FDA devised the black box as its strongest warning, appropriate when a product offers a twin combination of useful treatment and serious adverse effects. It is used sparingly, which strengthens its significance. An approved drug bearing the black box warning represents a considered decision that a product’s benefits may be

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12 Center for Responsible Lending, *Nine Signs of a Predatory Loan*, available at <http://www.responsiblelending.org/issues/payday/ninesigns.html> (stating that 75% of all payday consumers are unable to repay their loan and must get a “rollover”).

13 MANN, *supra* note 6, at 67.

14 See Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 U.C.L.A. LAW REV. 855, 897–98 (2007) (critiquing effectiveness of existing rollover bans).

15 *Id.* at 193 (describing benefits of this regulatory reform for credit cards).

16 *Cf.* MANN, *supra* note 6, at 204 (suggesting subordination of recovery in bankruptcy for credit card lenders would encourage credit card lenders to adjust lending practices to consumer distress).

so significant—even for a few people—that it outweighs severe or likely harm. A credit regulator might devise a parallel warning system for products that carry grave harm if misused. For example, payment option mortgages may be appropriate for people with varying incomes, such as commission sales people. A “black box warning” on such a mortgage could caution that the default rate on these products is many multiples of a fixed-rate loan and that such product frequently results in a serious side effect—foreclosure. The warning system might be preferable to banning credit products entirely. Like pharmaceuticals, most credit products can serve a socially useful purpose for some segment of the population in some circumstances.

I hope that a new agency is developed to tackle the structural weaknesses in the existing regulatory scheme for financial products. Bar-Gill and Warren convincingly explain the need for a fresh approach to protect households from economic risk. But my wish is to see a Credit and Debt Administration, a CDA so to speak, rather than a Financial Product Safety Commission, the FPSC of Bar-Gill and Warren’s parlance. Such a change is not mere acronymic adjustment. The FDA model offers a nuanced approach to testing, approving, and monitoring the use of financial products. Such a framework recognizes the sharp tension between risk and reward that inheres in consumer borrowing and would guide regulators to more sophisticated regulatory approaches.

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A Financial Product Safety Commission: The Need and The Challenge

As our nation's economic crisis spreads throughout the globe, high-level multi-national summits are attended, and billions of dollars are disbursed to keep the banks afloat, it's easy to forget that the catastrophe began with the pedaling of a toxic credit product: adjustable-rate sub-prime mortgages. Fueled more by demand from Wall Street than by demand from homebuyers or homeowners, a vast army of unregulated mortgage brokers barreled through down-on-their-luck neighborhoods offering salvation via cash-out refinancing in the form of exploding adjustable-rate mortgages. Contrary to popular perception, the majority of these mortgages weren't taken out by speculative investors, nor by middle-class families fulfilling their aspirations for ever-more home on an ever-shrinking income. In fact, in many cases, the mortgages were sold to existing homeowners, who were duped into trading their affordable fixed-rate mortgage for an ultimately unaffordable one. According to the *Wall Street Journal*, by the end of the refinancing boom, more than half of all sub-prime loans were going to people with credit scores that could have qualified them for traditional mortgages.

If something like the Financial Product Safety Commission (FPSC) had existed, we probably would not be living through the worst economic recession in our nation's history. As envisioned and originally conceived by Professor Elizabeth Warren, these mortgage products and the brokers who sold them, would have been yanked from the market—saving hundreds of thousands of homeowners from the devastation of foreclosure, or from declining home values caused by their neighbors' foreclosures. An FPSC could have removed these products from the market before they were commoditized into exotic financial instruments by investors and insurance companies. Quite simply, an FPSC would have prevented the whole complicated chain of events that resulted in the collapse of our economy.

While the sub-prime debacle is a case study in the canon of regulatory failures, it is but one tree in a rotting forest of abusive financial products. From bank overdraft lines to credit cards to pre-paid phone cards to payday lenders, the “innovation” of financial products has consistently been touted as benefiting

consumers, when in reality, much of the innovation is created to purposefully confuse people, siphon their money through hidden fees and routine transaction costs, and at worst, cause financial ruin.

The credit card market provides another sterling example of how deregulation has resulted in more costly products, particularly for low-income and households of color. With the ability to change the pricing of a card at “any time, for any reason,” cardholders are routinely hit with large fees and interest rate increases, often for minor infractions such as mailing a payment a day late, or going over the credit limit by mere pennies. A whole range of “gotcha” tactics has fueled the card companies' revenue—at great cost for consumers. In 2007, lenders collected a record \$18.1 billion in credit card penalty fees, up 69% from 2003, according to R.K. Hammer, a consulting firm. While the average interest rate on a card has declined since 1990, the trend masks significant increases in penalty interest rates, that are often levied for one late payment or charge over the credit limit—and applied retroactively to existing balances. According to research conducted by Demos, one-third of cardholders with balances carry interest rates higher than 20 percent on their cards—a trend absorbed disproportionately by African American, Latino and low-income cardholders.

The card companies claim they are simply pricing to reflect new risk—but they are under no scrutiny to prove their pricing models are sound or proportionate to the claimed risk. New rules issued by Federal Reserve Board, along with the Office of Thrift Supervision and the National Credit Union Administration, will finally address some of the more egregious practices, but it is likely only a matter of time before the card companies develop new practices in the same spirit as the old ones.

The capricious tactics of the credit card industry are not uncommon in the vast world of financial services products. Payday lenders, who have infested communities of color, offer deceptively low “fees” for short-term loans but in reality are charging upwards of 400 percent APR. A stroll through any predominantly Latino or African American neighborhood provides a guided tour of high-cost, deregulated credit: flyers everywhere

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promising cut-rate mortgages, check cashing store fronts, rent-to-own stores, “buy here, pay here” car lots, and of course, payday lenders.

While these financial products vary in their degree of cost and risk, each one is created and marketed to exploit the vacuum in consumer protection.

The current patchwork system of regulators overseeing consumer financial products—some 10 altogether—is ill-equipped, and even ill-designed to do the job of protecting consumers. Their clients are the banks or financial firms, not consumers. Historically, much consumer protection was provided through state law and oversight. But beginning in the late 1970s, usury protections and other credit regulations were all but nullified by legal rulings and legislative fiat.

Legislation to establish a Financial Product Safety Commission has been introduced in the House and Senate. But it’s likely to be a long and hard battle to become law. The powerful banking lobby will put up a serious fight. And so it’s important that supporters of an FPSC address what are likely to be key arguments used against the idea of an FPSC. As I see it, these arguments will include:

- Another regulatory agency isn’t necessary—there are already 10 agencies that have jurisdiction over financial products.
- An FPSC would stifle innovation and result in less choices for consumers.
- An FPSC would place more burdens on the banking system, which would result in higher prices for consumers.

These arguments are fairly easy to counter, but supporters will need to flesh out the details of the inner workings of an FPSC to ensure the widest possible coalition. For example, it is not inconceivable that at least one financial institution, particularly a bank, would support an FPSC because it would create a more level playing field between banks and non-banks. From that vantage point, an FPSC could facilitate a market where only the highest-quality products flourish, as opposed to continuing the race to the bottom that currently characterizes financial services.

The active endorsement of the civil rights community and labor community are also vital. Communities and individuals of color really have the most to gain or lose—the devil is in the details

and too often those details overlook what is happening in communities of color. In the case of an FPSC, there needs to be more explicit attention to a major detail: that toxic financial products are aggressively marketed to communities of color and as a result, African Americans and Latinos have suffered disproportionately under deregulation. In a 2008 survey of low- and middle-income Americans, Demos, a non-partisan public policy center, found that Hispanic and African-American households carried credit card debt twice the total value of their financial assets. White households, by comparison, tend to have more financial assets than credit card debt. The group United for a Fair Economy estimates that the total loss of wealth among households of color is between \$164 billion and \$213 billion as a result of subprime loans taken out during the past eight years—many of whom qualified for prime—rate products.

How might these issues be operationalized in the FPSC? It will mean monitoring marketing campaigns to see if similarly situated households are being offered different products

depending on where they live. It means devoting greater resources promoting the consumer hotline in communities of color to ensure the FPSC is getting information from the very consumers most likely to be offered toxic products. It also means enhancing data collection to account for race across the financial services sector. Already, mortgage data is collected by race and ethnicity. By extending the collection of race data to other lending industries—credit cards, auto loans, payday loans and so on—the proposed Commission can better police the lending industry and its treatment of consumers of color.

The time has come for an FPSC. Our nation’s current economic collapse is rightly viewed as the logical conclusion of a governing philosophy that eschewed regulation in almost any form, arguing that the hand of government was best kept behind its back. Millions of families have lost their homes—and millions more have lost their jobs, their retirement savings, their college aspirations—as a result of toxic products pushed by unregulated mortgage lenders and brokers, who often had the full backing of capital from august financial institutions and the full approval of existing regulatory agencies. It remains to be seen if this lesson will lead to transformative change such as the establishment of the Financial Product Safety Commission, or if the power of banking lobby will still be great enough to result in mere tinkering at the margins.

The current patchwork system of regulators is ill-equipped, and even ill-designed to do the job of protecting consumers.

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Particulars of a Financial Product Safety Commission

THE FPSC IDEA

“Why not create a Financial Products Safety Commission charged with responsibility to establish guidelines for disclosure, collect and report data about the uses of different financial products, review new products for safety, and require modification of dangerous products before they can be marketed to the public? The agency could review mortgages, credit cards, car loans, and so on. It could also exercise jurisdiction over life insurance and annuity contracts. In effect, the FPSC would evaluate these products to eliminate the hidden tricks that make some of them far more dangerous than others and ensure that none pose unacceptable risks to consumers. An FPSC would promote the benefits of free markets by ensuring that consumers can enter financial services markets confident that the products they purchase meet minimum safety standards.”

—Elizabeth Warren, “Product Safety Regulation as a Model for Financial Services Regulation,” *The Journal of Consumer Affairs*, 42 (3) 452–60 (2008).

“A financial products safety commission could help fill in the gap, particularly in relationship to products being produced by and invested in by regulated entities. Each product would have to have a stated objective (e.g. in what ways was it helping manage and mitigate risk; what was the risk profile for whom the product was intended). Its risk characteristics would be identified, using conservative models which paid due attention to the failures previously noted. The Financial Products Safety Commission would evaluate whether products provided significant risk mitigation benefits of the kind purported by the product. There would be a presumption that there “is no free lunch,” i.e., that higher returns could only be obtained at the expense of greater risk; and a strong assumption against complex products, the full import of which are hard to analyze.”

—Joseph Stiglitz, “The Financial Crisis of 2007/2008 and its Macroeconomic Consequences,” working paper; pp. 29–30 (2009).

PROPOSAL FOR EX ANTE APPROVAL POWER

What Professors Warren and Stiglitz describe is not unlike a new drug application (NDA) in American pharmaceutical regulation. A firm declares its purpose (including the disease to be treated, in what fashion, and how administered), and then produces evidence that the product in fact serves that purpose with minimal safety hazards. *The key is that for some products, government has veto power over market entry.* This veto power creates real incentives for the firm to produce good information. This document addresses the question: **What might approval regulation with some veto power over financial products look like?**

MODELS

- A. the new drug application process in U.S. pharmaceutical regulation (the “FDA” model)
- B. the pre-approval process for agricultural futures carried out by the CFTC¹
- C. “approval regulation” models²

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PARTICULARS OF A FINANCIAL PRODUCTS
SAFETY COMMISSION WITH EX ANTE
APPROVAL POWER

1. It includes at least some **veto power** over market entry, for at least some products. This is what makes the incentive system work—companies can profit from market revenues if and only if they experiment with sufficient intensity, independence and precision to satisfy the regulator’s higher standards. This system, and the information it produces, has created a global market for health treatments (worldwide, not just in the U.S.) that is much better informed. For all of its problems, a critical success story in global pharmaceuticals is the reliance of “consumers” (physicians and patients alike, as well as payors) on sound clinical trial evidence as the basis of use and consumption.
2. Another critical feature of the idea is to embed **experimental or quasi-experimental evidence** about financial products within regulation. So regulation is not just about the regulator’s veto power, but also about an institution whereby the veto player can be satisfied only through the production of a certain kind of evidence that proves the safety/efficacy of the product. For the FDA, this is randomized clinical trials; for financial products, this ought to include experiments but also different forms of evidence [see below].
3. Consider the possibility of **limited roll-out**, not unlike the conditional approval process or compassionate use procedure (proposed and in some cases tried) in pharmaceutical regulation. Let the sponsor/firm try out the product on a market of limited size (constraint can be geographic [e.g., roll it out only in Atlanta, Providence and Spokane], or can be market size [a total of \$10 billion]), and require the company to create experimental evidence during this roll-out period. If the roll-out shows problems, shut down or limit the market; if the roll-out shows advantages, expand the market or relax entry constraints entirely; if the roll-out shows neither, exploit the “continuation value” of further roll-out and keep the experimentation going.
4. **Different sorts of studies** can be done with the “data” produced by pre-market experimentation; social scientists can analyze randomized experiments with different treatments. Financial analysts can run simulation models as proposed by Prof. Stiglitz. Historians and legal scholars can discuss whether something like this has been tried before. Ethnographers can follow some of the people being “treated” with the new product and see how it affects them, helping to produce hypotheses and getting at other dimensions of human experience.
5. The key is partial or full **standardization** of products and of evidence. For example, the truth-in-lending law created the standard APR concept for interest rates.³ In pharmaceuticals, the modern market for generic drugs was created through bioequivalence regulations (1978) that demonstrated the substitutability of one drug form for another. These regulations made the Hatch-Waxman Act of 1984 (and its many benefits) possible.
6. **Transparency and disclosure need not imply erosion of competitive advantage:** (a) what is released in a good rating or “grade” is not all of the information but an appropriate summary statistic⁴ that simply and clearly conveys information necessary to make a better choice; (b) regulation can be designed so that particular information about products is known only to the regulator but not to all outside audiences (for all of its problems, the FDA does do a good job of keeping trade information confidential).
7. Consider an **advisory committee system** to protect against capture and/or to disclose the extent of disagreement about products. Here, too, you can think of an advisory committee system as releasing “summary statistic” information about a product—such as the vote for or against approval of a product, or more elaborately, the transcript of the public discussion.
8. **What sorts of products** can we imagine being regulated in this way? Consider the following. (1) ARMs with teaser rates, (2) pay-day lending, (3) new credit cards, (4) annuities, life

1 This model was suggested by Michael Greenberger, former Director of the Division of Trading and Markets at the CFTC.

2 See Carpenter, D.P. and M. M. Ting. 2007 “Regulatory Errors with Endogenous Agendas,” *American Journal of Political Science* 51 (4) (October); Carpenter, D.P., “Protection without Capture: Product Approval by a Politically Responsive, Learning Regulator,” *American Political Science Review* 98 (4) (November 2004) 613–31; Carpenter, D. and Grimmer, J. “Approval Regulation and the Endogenous Provision of Confidence: Theory and an Analogy between Financial and Safety Regulation,” working paper, April 2009.

3 This example was contributed by Daniel Goroff, Program Director at the Alfred P. Sloan Foundation.

4 In the best case, this is a “sufficient statistic” in the sense that it allows a consumer or regulator or other audience to construct optimal strategies or policies for their own problems without any additional information. This is unlikely but can be considered a best case scenario that regulation might wish to approximate. The Carpenter and Ting (2007) and Carpenter and Grimmer (2009) models offer a posterior Beta distribution that serves mathematically to tie down the perfect Bayesian equilibrium in which information is produced.

insurance and longevity insurance products, etc., (5) collateralized debt obligations, (6) securitized vehicles (synthetic securities), (7) credit default swaps (including their standardization), and/or (8) check-cashing, remittances, pawn shops, tax refund anticipation loans, debit cards, payment mechanisms. A lot of the products discussed in Soros, *The Crash of 2008 and What It Means*,⁵ could in principle also be regulated.

9. **The problem of interconnected products (“systemic risk”):**

In a pre-approval experimental world, or in a roll-out world, it is essentially impossible to isolate the effects of a “treatment” (a new financial product), given that one treatment ends up getting involved in all sorts of others. Note that this is what scholars of causal inference call an “external validity” problem—can we extrapolate from an experiment to the situations in which this treatment/product will actually be used? Note first that medical studies face this problem all the time, and yet it does not prevent regulation or experiment from working; it is possible to include multiple treatments in an experiment, as well as to use observational data (“epidemiology”) to examine interactions among different kinds of medications. Second, this seems like a ripe possibility for simulation modeling. The Commission could use computationally intensive simulations (see brief discussion of this below) to test out some of the effects, using large matrices or

graphs of connectivity, or could even set up simulations like Sim City in which both small-N and large-N games of players lend to each other and create new financial instruments, and explore different regulatory strategies for these products. Put differently, the Commission could create simulated experiments or limited experiments where people don’t get killed or where the harm that is observed is bounded in some way.

10. **The problem of administrative turf**⁶: this is perhaps the most difficult problem of all, at least in my thinking. Congress and scholars of administration (administrative law, political science and public administration, organizational sociology) will need to be consulted to think about how this might work.

11. Finally, **there is no necessary or strong relationship between approval regulation and reduced innovation in the regulated market.** The most productive years of the American and global pharmaceutical industries (not to mention massive improvements in chronic health conditions) came after the establishment of regulatory veto power in 1938. Also large-scale improvements in health technology and its use following 1962. This is always a concern to keep in mind, but the evidence for reduced innovation as a result of pharmaceutical regulation is non-existent or, where claimed, extremely weak. See Philip Hiltz, *Protecting America’s Health*,⁷ for a general refutation.

5 Soros, G. 2009. *The Crash of 2008 and What It Means*. New York: Public Affairs.

6 This issue was raised by James Segel, Special Counsel to Congressman Barney Frank.

7 Hiltz, P. 2003. *Protecting America’s Health: The FDA, Business, and One Hundred Years of Regulation*. New York: Knopf.

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Initial Thoughts on a Financial Product Safety Commission

Credit default swaps, option ARMs, CDOs—these are among the best known financial products of recent vintage whose misuse and/or lack of transparency have contributed to the current financial crisis. To prevent recurrences, thought is now being given to creating a “Financial Product Safety Commission.” Is there a case for such an institution, and if so, what would/should it do?

Clearly, we knew before this crisis, and certainly know now that we are suffering from it, that financial markets do not function well, and can even be dangerous unless consumers/users are reasonably informed of the benefits, costs, and risks of using and trading the products or instruments found in these markets. Some purists believe that markets can generate on their own sufficient information for this purpose. On this view, if producers/innovators sell defective or dangerous products, consumers will quickly find out, and market punishment will be swift. Accordingly, producers have incentives only to put out safe products and/or to warn users of their dangers, especially in a legal environment in which they can be sued if things turn out badly.

There are a number of problems, however, with relying on the market and liability lawsuits to protect consumers/users from dangers. As for the market, producers who have one-time interactions with purchasers may have insufficient incentives to be prudent or to provide the appropriate level of disclosure. This is especially true where the dangers may not show up for some time, as was the case with little or no money down mortgages with teaser interest rates: as long as home prices kept climbing, borrowers could refinance without the mortgage lender (who very likely sold the mortgage to a securitized pool) suffering any material loss. Meanwhile, the lender who originated the imprudent loan would find many other victims before ever being found out (and, as long as home prices continued to climb, that day presumably would be many years into the future).

Liability lawsuits also are imperfect means of assuring product quality and adequate disclosure, generally and more specifically with respect to financial products. Here, too, there can be ample time between the time a defective or dangerous product is sold

and when the seller is held accountable. Moreover, there is a huge amount of randomness or uncertainty about what kinds of disclosures/warnings may emerge from the judicial process; it depends on the particular venue, a particular jury or juries, and particular judges. To put it differently, the judicial process is not one that is accustomed to producing finely crafted rules reflecting a careful balancing of benefits and costs.

For these reasons, and presumably others, policy makers have introduced basically three kinds of regulation of products and services sold to the public: occupational licensing of providers, such as doctors, lawyers, and stock and insurance brokers (aimed at assuring the quality of the services they provide); product quality regulation (to ensure a certain degree of safety, as in the case of pharmaceuticals and automobiles; or to protect the environment, such as mandated pollution control devices or cap and trade systems to give market-like incentives for controlling/reducing pollution); and disclosure requirements (cigarettes, food content, patient packet inserts for drugs to warn of side-effects; and financial disclosure rules for all companies and those offering publicly traded securities).

Given the current crisis, the question now is: should we go further in the financial arena and formally establish a Financial Products Safety Commission (FPSC)—presumably a federal entity that would have some oversight/control over the safety of all or some subset of financial products? The Treasury Department under Secretary Paulson issued a report in March 2008 recommending a sweeping restructuring of the current federal/state financial regulatory structure which, among other things, recommended that all federal financial regulation be consolidated into two broad agencies: one overseeing the solvency of federally regulated financial institutions, and the other with jurisdiction over consumer protection. (The Paulson Treasury also recommended that the Fed have a “free safety” role as a systemic risk regulator, but that is a subject for another—much longer—essay).

In suggesting the consolidation of existing financial protection regulation in a single agency, the Paulson report anticipated current notions of a formal FPSC. Whether such a commission

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is a good idea depends, in large part in my view, on answers to the following questions:

- Should the FPSC only have jurisdiction for financial products meant for consumers and unsophisticated investors (mortgage, retail investment products), or should its jurisdiction extend to wholesale or institutional products, such as derivatives, which can have systemic implications? My initial view is that, if established in some form, it should do both, but I can see a case for doing one or the other.
- Should such an entity consolidate all existing consumer protection regulatory authority now spread out among federal financial regulatory agencies (SEC, CFTC, FTC, banking agencies) and the state counterparts (including insurance), or existing alongside these existing agencies but only regulate/require disclosure relating to *new consumer products* (and thus not handle consumer complaints and the like). Here, my initial view is that it would be hard to limit the agency only to focusing on new products, without also having some role in hearing and resolving consumer complaints, so that it can be informed about how refine any initial determinations it may have.
- Perhaps most importantly, should the FPSC screen financial products in advance, (much as the FDA does for pharmaceuticals, or state insurance commissions do for the contents of insurance contracts) or should it regulate (including imposing disclosure requirements) products on an after-the-fact basis, as problems arise and upon proof that a product or an aspect of a product entails more social harm than good (as is the case with virtually all other consumer protection)? I fully realize the temptation in light of this crisis is to ask the agency to be more proactive and to act like FDA and approve the safety, if not the efficacy, of at least consumer, if not wholesale, financial products in the future—both to protect consumers, and to prevent a product such as the next evolution of the CDO from posing significant systemic risks to the economy. Thus, for example, is not a mortgage or a credit card agreement just as complex as an insurance contract? Since it seems a given that either the state or federal government will continue to approve insurance contracts, does this not imply that the FPSC should do the same for mortgages and credit card contracts? Ditto for future evolutions of securitized instruments?

I urge caution in jumping to an FDA-like pre-approval regime for financial products. Instead, I believe for several reasons the

presumption should favor post-market scrutiny of financial products—and thus possible regulation or mandatory disclosures if the benefits outweigh the costs—as we do for consumer products generally:

First, it should not be a given that even complex contracts such as all insurance forms require approval before sale. A strong case has been made in the scholarly literature that, at the very least, insurance contracts sold to business purchasers should no longer be pre-approved; requiring approval has slowed innovation and raised costs for purchasers.

Second, the FDA analogy does not fit well to financial products. It is hard to imagine conducting “clinical trials” for new financial products like those conducted first on animals (mostly mice) and then on people for new drugs. How would the human subjects be chosen, and how meaningful would be the results? One cannot easily tell from any sample what kinds of risks and benefits would materialize if an entire population were exposed to a new financial product—until we find out from the marketplace. Only when such products are sold and problems surface are policy makers in a position to determine whether and how such problems should be fixed.

Third, because the political costs of missing a future problem are much greater than the costs of failing to approve a worthwhile new financial product (how would one ever know?), there will inevitably be a strong anti-innovation bias to any pre-approval process for new financial products. There are negative consequences or harms associated with virtually all new technologies that survive a market test. Think about accidents and deaths/injuries associated with the automobile, airplanes, railroads, and electricity; or the dangers now emerging as a result of the Internet. A risk-averse regulator also could have imagined these outcomes at the outset. Had any of these technologies or products thus been subject to a pre-approval process, it is possible, if not likely that none or few of them ever would have made the cut.

Finally, any FPSC will need to resolve the thorny definitional issue of “what is a financial product?” Do warranties on all products count? Return policies? Anything “contract” that involves money? Resolution of this issue probably is more important if the agency’s job is to approve all such products or contracts in advance—nothing is allowed unless permitted—than if the agency simply has the right to regulate after the fact if it has evidence of social harm outweighing any social benefits.

Presumption should favor post-market scrutiny of financial products.

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THE FINANCIAL PRODUCT SAFETY COMMISSION:

Learning from Experience to Better Protect Consumers and the Economy

INTRODUCTION

As Americans learn more about the events that have led to the current economic crisis, it has become clear that a major cause of the most calamitous worldwide recession since the Great Depression was the simple failure of federal regulators to stop abusive lending, particularly unsustainable home mortgage lending. Such action would not only have protected many families from serious financial harm but would likely have stopped the chain of events that has led to the economic crisis.

As a result, public policy makers have begun an active search for solutions that will ensure that this type of crisis never occurs again. Key Congressional leaders and leading academics have endorsed a proposal by Harvard Professor Elizabeth Warren to create a single agency that ensures that credit products are safe. The sole mission of this agency would be to require that lenders offer credit on terms that are fair to and sustainable by borrowers.

The idea of a Financial Product Safety Commission is gaining support because it targets the most significant underlying causes of the massive regulatory failures that occurred. First, federal agencies did not make protecting consumers their top priority and, in fact, seemed to compete against each other to keep standards low. When agencies did act to protect consumers, the process was cumbersome and time-consuming. As a result, agencies did not act to stop some abusive lending practices until it was too late. Finally, regulators were not truly independent of the influence of the financial institutions they regulated.

Meanwhile, despite an unprecedented government intervention in the financial sector, problems with the sustainability of home mortgage and consumer loans keep getting worse. With an estimated two million households having already lost their homes to foreclosure because of unsound loans, Credit Suisse now predicts that foreclosures will exceed eight million through 2012. The amount of revolving debt, most of which is credit card debt, is approaching \$1 trillion, and more Americans are delinquent

or in default on their credit card loans than at any time since the recession of 2001 and 2002. Based on the losses that credit card issuers are now reporting, delinquencies and defaults may peak at their highest levels ever by the end of this year. One in two consumers who get payday loans default within the first year, and consumers who receive these loans are twice as likely to enter bankruptcy within two years as those who seek and are denied them. Overall, personal bankruptcies have increased sharply, up by one-third percent in the last year.

FEDERAL CONSUMER PROTECTION FAILURES CONTINUE

The failure of federal banking agencies to stem sub-prime mortgage lending abuses is fairly well known. They did not use the regulatory authority granted to them to stop unfair and deceptive lending practices before the mortgage foreclosure crisis spun out of control. In fact, it wasn't until July of 2008 that these rules were finalized, more than five years after analysts and experts started warning that predatory sub-prime mortgage lending would lead to a foreclosure epidemic. Less well known are continuing federal regulatory failures that have contributed to the extension of unsustainable consumer loans, such as credit card, overdraft and payday loans, which are now imposing a crushing financial burden on many families.

For example, federal regulators refused for years to rein in abusive and unsustainable lending practices by credit card companies that affected millions of consumers. At their lending peak, card issuers offered more than \$5 trillion in credit to Americans that the companies marketed with over six billion card solicitations. The practice of increasing the interest rates on cardholders' outstanding balances for questionable reasons, which began in the late 1990s, has almost certainly contributed to the financial insecurity of millions of households that are delinquent or in default on their credit card loans. Similar concerns have been raised about aggressive marketing of unsustainable loans to college students, high penalty fees assessed for minor transgressions,

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and payment allocation methods that prolong the time it takes to pay off loans. It wasn't until May of 2008 that federal regulators changed course and considered forbidding or restricting some of these practices. However, these rules won't take effect until the middle of 2010.

Americans spend about \$17.5 billion annually on high-cost overdraft loans, which federal regulators continue to allow without consumer consent. Just like their much-criticized cousins—payday loans—overdraft loans that are unilaterally provided by banks impose astronomical costs on cash-strapped consumers (a 3,520 APR for a two-week debit card loan is typical), trap consumers into a pattern of repeat borrowing, put bank account ownership at risk, and have a disparate impact on young and low-income borrowers. The Federal Reserve Board has refused to require banks to comply with the Truth in Lending Act when they issue these loans. Customers are permitted to overdraw their accounts without signing up for the credit, without getting cost-of-credit disclosures, and without receiving a contract that the bank will in fact pay for overdraft transactions. Only now is the agency considering adopting consumer protection rules that, as proposed, fail to address some of the most serious abuses with overdraft loans.

Federal regulators also fueled the explosive growth of payday lending during the late 1990s and early 2000s by allowing loan companies to partner with banks to evade state protections. Payday lenders solicit consumers to write unfunded checks for immediate cash loans that are due in full on the borrower's next payday, in order to keep the check from bouncing. By claiming the right to "export" weak regulations from the states where their bank partners were based, payday lenders charged interest rates of 400 percent and higher in states with stronger laws. Although the OCC and OTS began the lengthy process of stopping the banks they regulate from partnering with payday lenders in 2000, it wasn't until 2006 that the FDIC brought rent-a-bank payday lending to a close.

All of the failures cited above are in areas where federal regulators had existing authority to act, and either chose not to do so or acted too late to stem serious problems in the credit markets. An ideological predisposition or anti-regulatory bias by federal officials, rather than gaps in the regulatory structure, were the main reasons they did not attempt to rein in abusive lending before it triggered the housing and economic crises. However, structural flaws in the federal regulatory system compromised the independence of banking regulators, encouraged them to overlook or ignore their mission to protect consumers, created a dynamic in which agencies competed 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 most diligent policies and intentions. They complicated enforcement and vitiated regulatory responsibility to the ultimate detriment of consumers.

These structural flaws include: a narrow focus on "safety and soundness" regulation to the exclusion of consumer protection; the huge conflict-of-interest that some agencies have because they rely heavily on financial assessments on regulated institutions; the balkanization of regulatory authority between agencies that often results in either very weak or extraordinarily sluggish regulation (or both); and a regulatory process that lacks transparency and accountability. Taken together, these flaws severely compromised the regulatory process and made it far less likely that agency leaders would either act to protect consumers or succeed in doing so.

CORRECTING STRUCTURAL SHORTCOMINGS BY CREATING A FINANCIAL PRODUCT SAFETY COMMISSION

Although a Financial Product Safety Commission (FPSC) would not be a panacea for all current regulatory ills, it would correct many of the most significant structural flaws that exist, realigning the regulatory architecture to reflect the unfortunate lessons that have been learned in the current financial crisis and sharply increasing the chances that regulators will succeed in protecting consumers in the future. A FPSC would be designed to achieve the following regulatory goals.

1. Put Consumer Protection at the Center of Financial Regulation.

Right now, regulatory agencies are required both to ensure the solvency of the financial institutions they regulate and to protect consumers from lending abuses. Within agencies in which these functions are combined, regulators have often treated consumer protection as less important than their safety and soundness mission or even in conflict with that mission. For example, an agency focused almost exclusively on what is financially beneficial for banks would likely view a restriction on overdraft loans as a threat to the bank's financial stability, even if this type of loan is deceptively offered and financially harmful to consumers. Similarly, if regulators believe that ensuring that the short-term balance sheets of the institutions they regulate is their paramount goal, they are less likely to perceive that questionable practices like mortgage prepayment penalties or credit card universal default are harmful to consumers.

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Recent history has demonstrated that this narrow, short-sighted view of consumer protection and bank solvency is fatally flawed. If regulatory agencies had acted to prevent loan terms that harmed consumers, they would also have vastly improved the financial solidity of the institutions they regulated. However, the disparity in agencies' focus on consumer protection versus "safety and soundness" was obvious, both in the relative resources that agencies devoted to the two goals and in the priorities they articulated. These priorities frequently minimized consumer protection, but often included reducing regulatory restrictions on the institutions they oversaw.

Regulatory agencies have also focused almost exclusively on bank examination and supervision to protect consumers, which lacks transparency. This process gives bank regulators a high degree of discretion to decide what types of lending are harmful to consumers, a process that involves negotiating behind-the-scenes with bank officials. The process also results in different standards for products like credit cards offered by different types of financial institutions. In fact, widespread abusive lending in the credit markets have discredited claims by bank regulators like the Comptroller of the Currency that the process 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.

A FPSC, by contrast, would have as its sole mission the development of standards that ensure that all credit products offered to borrowers are safe. The agency would then enforce these standards in a transparent, uniform manner. Ensuring the safety of credit products would mean that the FPSC would not allow loans with terms that are deceptive or fraudulent. "Safety" is a much broader concept though, designed to ensure that credit products are also fair and sustainable. In fact, a core mission of the FPSC would be to ensure that borrowers truly have the ability to repay the loans they are offered, that the cost of the loan does not suddenly or sharply increase, and that the terms of the loan do not impose financial penalties on borrowers who try to pay it off. As we've learned in the current crisis, focusing exclusively on consumer protection would be positive for lenders' stability and soundness over the long term. However, the agency would be compelled to act in the best interest of consumers even if measures to restrict certain types of loans would have a negative short-term financial impact on financial institutions.

Focusing exclusively on consumer protection would be positive for lenders' stability and soundness over the long term.

2. Create an Independent Regulatory Process.

The independence of the current financial regulatory process has been compromised by regulatory agencies that are directly and almost entirely funded by the institutions they oversee. This funding creates a significant conflict-of-interest and has contributed to the agencies' disinclination to consider upfront regulation of the mortgage and consumer credit markets. The most serious funding conflicts exist with the Office of Thrift Supervision (OTS) and Office of the Comptroller of the Currency (OCC), both of which receive significant proportions of their annual budget from assessments on a relatively small number of large, regulated institutions. The OTS has become notorious for its dismal record in regulating the safety and soundness of such failed institutions as Washington Mutual, Countrywide and the financial products division of AIG, which was largely responsible for that company's insolvency and takeover by the U.S. government. The OCC has had a very spotty track record in using its existing authority to protect consumers. For example, it has taken public enforcement action against major credit card issuers only twice in recent years, most notably in a case involving deceptive marketing practices by Provident.

However, this occurred only after the San Francisco District Attorney and California Attorney General initiated action. Meanwhile, state officials and other federal agencies issued numerous enforcement orders against leading national banks or their affiliates for a variety of abusive practices during the same period.

The leadership of an FPSC would be held to account based on its ability to protect consumers from unsafe products. In order to function effectively, the leadership would need to show expertise in and commitment to consumer protection. Crucial to the success of the agency would be to ensure that its funding does not compromise this mission. Funding the agency through Congressional appropriations would not involve the same inherent conflict-of-interest as does the direct assessment of a small number of regulated institutions, some of which can choose another regulator if they wish. Of course, the appropriations process is still subject to political manipulation by well-funded special interests working with a sympathetic Administration or Members of Congress. However, Congressional funding is more transparent than the murky process of direct assessment, less subject to pressure from a small number of institutions and, if conducted without political interference, offers the possibility of "clean" funding.

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If Congress decides that it will not fully fund the agency through appropriations, there are still methods of industry funding that involve fewer conflicts-of-interest than does the present direct assessment system. For example, Congress could require that all funding collected from regulated institutions for safety and soundness or consumer protection purposes be pooled and distributed to agencies via an independent, inter-agency process based on need that receives input from consumer representatives. Another approach would be to allow the FPSC to supplement appropriations by giving it full authority to set prices that it would charge a creditor for particular activities, such as assessing the safety of a new credit product.

Congress could also ensure that the method of agency funding that is used does not compromise the FPSC's mission by building accountability mechanisms into the authorizing statute and exercising effective oversight of the agency's operations. The agency could be required to meet rigorous consumer protection "performance goals," for example, and to regularly report to Congress on the effectiveness in achieving these goals. Congress could also require that the agency seek out and respond to consumer complaints and input regarding credit products and include those with consumer expertise in advisory and governance roles.

3. Prevent Regulatory Arbitrage.

Act Quickly to Prevent Unsafe Forms of Credit.

The present regulatory system is institution-centered, rather than consumer-centered. It is structured according to increasingly irrelevant distinctions between the type of institution that is lending money, rather than the type of product being offered to consumers. Right now, 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. Many financial institutions have switched charters in recent years seeking regulation that is less stringent. Two of the most notorious examples are Washington Mutual and Countrywide, which have become infamous for promoting dangerous sub-prime mortgage loans on a massive scale. Both switched their charters to become thrifts regulated by the Office of Thrift Supervision. At the federal level, where major agencies are funded by the institutions they oversee, this ability has undeniably led regulators like the OTS to compete to attract financial institutions by keeping regulatory standards weak. It has also encouraged the OCC to expand its preemptive authority and stymie efforts by the states to curb predatory and high-cost lending. In fact, the OCC has marketed its broad preemptive authority over state consumer protections and its aggressive

legal defense of that authority to attract depository institutions to its charter.

When agencies do collaborate to apply consumer protections consistently to the institutions they regulate, the process has been staggeringly slow. As cited above, federal regulators dithered for years in implementing regulations to stop unfair and deceptive mortgage and credit card lending practices. One of the reasons for these delays is often 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 drag out the process. Although the recently adopted credit card rule was ultimately finalized over protests from the OCC, these objections were likely one of the reasons that federal regulators delayed even *beginning* the process of curbing abusive credit card lending practices until mid-2008. The rule that was adopted won't take effect until July of 2010.

"Charter shopping" is the problem that would be most clearly solved through the creation of a single FPSC with regulatory authority over all forms of credit. Federal agencies would no longer compete to attract institutions based on weak consumer protection standards. The FPSC would be required to focus on the safety of credit products, no matter what kind of lender offered them. As for regulatory competition with states, it should only exist to improve the quality of consumer protection. Therefore, the FPSC should be allowed to set minimum national credit standards, which states could then enforce. States should be allowed to exceed these standards if local conditions require them to do so, but it is unlikely that this will happen very often if the FPSC is thorough and effective. Moreover, the agency would have a clear incentive to stay abreast of market developments and to act in a timely fashion to rein in abusive lending because it will be held responsible for developments in the credit market that harm consumers.

CONCLUSION

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 meddling 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 very unlikely that consumers will be adequately protected from unwise or unfair credit products in the future. The creation of a FPSC is necessary because it ensures that the paramount priority of federal regulation is to protect consumers, that the agency decision-making is truly independent, and that agencies do not have financial or regulatory incentives to keep standards weaker than necessary.