

Demonstrative Consumer Regulation by the Federal Reserve – An Exercise in Reputation- and Turf-Based Governance?*

Daniel Carpenter[†]

March 16, 2010

In the year since President Obama took office, a debate has raged between Wall Street and Washington about how to respond to the global financial crisis. The most controversial proposal has been to create an independent regulator for consumer financial products – the Canadian government established such an agency almost a decade ago. The independent agency proposal surfaced in the writings of Harvard legal scholar Elizabeth Warren in a 2007 essay, and the idea became legislatively tangible in March 2009, when it was formally introduced to Congress. In the year following the introduction of this proposal, the independent agency idea has been supported and attacked, surpassed only by health care and perhaps Afghanistan as front-page news and a front-burner priority for politicians.

In this draft essay I contend that much of the action has occurred not in the press but in the existing regulatory arena. Status quo government agencies with turf to protect – mainly the Federal Reserve – have been shifting their rhetoric and their action. In nearly lock step as the possibility of an independent financial regulator has surfaced, existing regulators have changed the themes of their rhetoric and the apparent frequency and substance of their action. For political scientists and students of the federal bureaucracy, this is not surprising; government agencies compete for turf and show their best cards to their audiences all the time.¹ Neither journalists nor scholars have given much attention to these actions, and I have noted elsewhere that some of the same legislators and voices who publicly worry about an independent financial agency have refrained from criticism of these less visible moves.

The shift is most pronounced at the Federal Reserve. It would appear from public opinion surveys that the Federal Reserve is increasingly unpopular, not just among liberals and progressives but also among conservatives and libertarians. The historically narrow margin of confirmation for Fed chairman Ben Bernanke earlier this year would seem to provide supportive evidence for that hypothesis. Much of the proposed and actual new regulation of consumer finance markets has come in the last year, and much of it has come from this agency. Yet judging from its own statistics and speeches, the Fed has come only recently to the issue of consumer protection, and the shift became especially dramatic when Congress took up the idea of an independent agency, Elizabeth-

***This paper is a draft, is preliminary, and has not been peer-reviewed; I am circulating it for discussion only.** Please inform me of any comments or corrections by message to dcarpenter@gov.harvard.edu

[†]Allie S. Freed Professor of Government and Director, Center for American Political Studies, Faculty of Arts and Sciences, Harvard University; e-mail: dcarpenter@gov.harvard.edu. For support on earlier and ongoing work for this project, I thank the National Science Foundation, the Robert Wood Johnson Foundation Scholars in Health Policy Program, a Robert Wood Johnson Foundation Investigator Award in Health Policy Research, and the Tobin Project. The arguments and characterizations herein are mine alone, and bear no relation to the views of these entities.

¹See Hugh Hecl and Aaron Wildavsky, *The Private Government of Public Money* (London: Macmillan, 1974), 14-15; Jonathan R. Macey and Geoffrey P. Miller, “Reflections on Professional Responsibility in a Regulatory State,” 63 *Geo. Wash. L. Rev.* 63 (1994-1995) 1105; Daniel Carpenter *Reputation and Power: Organizational Image and Pharmaceutical Regulation at the FDA* (Princeton: Princeton University Press, 2010); George A. Krause and James Douglas, “Institutional Design versus Reputational Effects on Bureaucratic Performance: Evidence from U.S. Government Macroeconomic and Fiscal Projections” *Journal of Public Administration Research and Theory* 15 (2) (2005) 281-306; Moshe Maor, “Organizational Reputation and Jurisdictional Claims: The Case of the U.S. Food and Drug Administration,” *Governance* 23(1): 133-159; Maor, “A Scientific Standard and an Agency’s Legal Independence: Which of these Reputation-Protection Mechanisms is less Susceptible to Political Moves?”, *Public Administration*, 85(4): 961-978.

Warren style. In this draft essay I provide evidence of this shift and discuss its consequences for understanding federal regulation.

1 Reputation, Turf and Regulatory Behavior

There are many ways to understand regulation. Two of the most common understandings in regulation are *public interest theory*, which emphasizes regulation's status as a democratic response to instabilities or abuses in the market, or *capture theory*, which points to regulation as a form of redistribution (from consumers and smaller producers to larger and more established firms in the market or to politicians). In recent years, scholars in the social sciences have been increasingly concerned with how the concerns of regulators themselves affect the policies and enforcement behavior that we see. Some of this research is classic, such as the skilled argument by economist Paul Joskow that utility regulators worried more about nominal gas and electricity prices (the numbers that consumers and voters see) than about real prices (the observed numbers adjusted for inflation).² Brown University political scientist Susan Moffitt has adduced evidence that public image considerations are important for the FDA in determining whether and when it will call an advisory committee meeting, while Israeli political scientist Moshe Maor has shown that similar audience-based considerations influence the FDA's issuance of warning letters. Other research has demonstrated that reputation and audience considerations shape government budget forecasts.³

The lesson of this scholarship is that, when trying to account for a regulator's behavior, *look at the audience*, and *look at the threats*. Agencies are often concerned less about losing money than they are about their turf and their discretion. When it would appear that the regulators have performed poorly in a given area, the criticism they receive and the threats to their turf and resources may rise. Structural problems in the regulator's environment may not be amenable to change; it is also possible that the regulators in question may not wish to effect structural transformation of the sphere they govern. Yet more cosmetic changes are available for regulators who either cannot or do not wish to create fargoing structural transformations. In the case of financial regulators – especially those with some form of authority over the amorphous but vital area of consumer protection – the main criticisms came in the wake of the financial crisis, and the principal audience was the American public and in particular Congress, which was the institution best positioned to threaten status quo regulators with a loss of their turf, resources or both.

2 The Emergence of a Threat

The idea for a new independent consumer agency surfaced in 2007, when Harvard law professor Elizabeth Warren authored the idea in an essay in the journal *Democracy* (Summer 2007). But the idea did not become tangible or threatening to existing regulators with turf to protect until March 2009, when a bill creating a financial product safety commission (FPSC) was introduced in the House of Representatives. The announcement for this bill came on March 5, 2009.⁴ The formal bill introduction to the Senate occurred on March 10th.⁵ A number of web-based news sources also

²Joskow, "Inflation and Environmental Concern: Structural Change in the Process of Public Utility Price Regulation," *Journal of Law & Economics*, 17(2) (October 1973): 291-327.

³Maor, "Organizational Reputation and Jurisdictional Claims: The Case of the U.S. Food and Drug Administration"; Maor, "A Scientific Standard and an Agency's Legal Independence: Which of these Reputation-Protection Mechanisms is less Susceptible to Political Moves?"; Krause and Douglas, "Institutional Design versus Reputational Effects on Bureaucratic Performance: Evidence from U.S. Government Macroeconomic and Fiscal Projections."

⁴The timing of this bill introduction is one that I interpret as providing an important threat, although agencies such as the Fed and the FTC may have learned earlier that the bill introduction was coming. Announcement of House bill introduction on March 5th, 2009; see <http://blog.affil.org/2009/03/elizabeth-warrens-financial-product-safety-commission/>.

⁵From the GovTrack website (<http://www.govtrack.us/congress/bill.xpd?bill=s111-566>) and the Library of Congress' Thomas site (<http://thomas.loc.gov/cgi-bin/bdquery/z?d111:s.00566>); see "The Financial Product Safety Commission Bill # S.566" – status – 03/10/2009: Read twice and referred to the Committee on Banking, Housing,

began to discuss the legislative proposal for a new commission around this time,⁶ and President Obama mentioned the idea in an appearance that month on the Tonight Show with Jay Leno.⁷

In the bills introduced to Congress, and in the Obama Administration’s proposal as released in June 2009, there were clear threats to the turf of what may be called the “status quo regulators” of U.S. consumer finance. What was undoubtedly concerning to officials at the Fed, the Federal Deposit Insurance Corporation (FDIC), the Federal Trade Commission (FTC) and other agencies is that significant parts of their governing authority (that one might call their policy “turf”) and in some cases their budgets and personnel would stand to be transferred to the new consumer agency. The FTC was one of the agencies to circle wagons most forcefully. Commissioner William E. Kovacic read the Administration’s bill as transferring ‘all consumer financial protection functions of the Federal Trade Commission’ to the new agency. Kovacic also saw the legislation as defining “consumer financial protection functions so broadly as to include ‘research, rulemaking, issuance of orders or guidance. . . .’ This expansive definition would include the Bureau of Economics research as well as the FTCs enormously valuable public workshops and consumer education programs.”⁸ Kovacic saw in the bill an affront not merely to the agency as a whole, but to its Bureau of Economics and its Bureau of Competition in particular. Indeed, Kovacic’s defense of the Commission was so strong that he saw the financial crisis as a rationale for *expanding* the powers and responsibilities of the FTC: “Rather than divest the FTC of all of its consumer financial protection functions and give it hollow backstop authority, a more promising approach could be to remove jurisdictional limits that currently constrain the FTCs regulatory and enforcement authority in the financial services sector.”⁹

Yet given the size and expanse of the Federal Reserve – and its privileged funding structure among government agencies – it is not surprising that the Federal Reserve’s mobilization against the CFPA has been larger and more forceful. Some observers see in the CFPA proposal the largest threat to the Fed in four decades.¹⁰ The bill currently under consideration by the Senate creates and authorizes the transfer of authorities, funds and personnel from a number of national agencies, most notably the Federal Reserve.¹¹ Beyond this, the proposals have some of the CFPA’s funding coming directly from the Fed. This change is significant, given that the Federal Reserve’s funding model differs from that of most federal agencies is that it is fee-based and less visible to the taxpayer. Because the Federal Reserve, that weakens the link between its fee-based revenues and aggregate taxpayer limitations. Of course, American consumers pay for the Federal Reserve’s operations nonetheless, because banks undoubtedly pass along the direct costs of the fees (and the “indirect” administrative or compliance costs of paying them) to their customers. Banks and other lender organizations lobby

and Urban Affairs. (text of measure as introduced: CR S2975-2978); 03/10/2009: Sponsor introductory remarks on measure. (CR S2974-2975) ; Committee/Subcommittee Activity: Banking, Housing, and Urban Affairs: Referral, In Committee

⁶See for instance the web report from the left-leaning website *The Huffington Post* on March 10, 2009: http://www.huffingtonpost.com/2009/03/10/financial-product-safety_n_173691.html

⁷The White House supports “getting back to some common sense regulations” when it comes to consumer financial products, President Obama said during his March appearance on the “Tonight Show” with Jay Leno”; see <http://www.marketwatch.com/story/new-agency-would-protect-consumers> (accessed February 21, 2010).

⁸Kovacic’s remarks are available in a Commission-hosted publication; “The Consumer Financial Protection Agency and the Hazards of Regulatory Restructuring,” *Lombard Street*, 23. The publication is available at the Commission’s website: <http://www.ftc.gov/speeches/kovacic/090914hazzrdsrestructuring.pdf> (accessed February 21, 2010).

⁹Kovacic, “The Consumer Financial Protection Agency and the Hazards of Regulatory Restructuring,” *Lombard Street*, 25.

¹⁰See “Deal near on Senate financial reform bill, Business Digest, *The Washington Post*, December 24, 2009; On the magnitude of the threat, Vanessa Cross of Suite 101 writes that “According to financial analysts,...the proposed 1136 page Senate bill poses the biggest challenge to the Fed’s independence since it was codified into law in the 1970s”; Vanessa Cross, “Bipartisan Financial Reform Bill in U.S. Senate: Federal Reserve Board Chairman Bernanke Lobbies Against Reformation,” available at http://business-market-analysis.suite101.com/article.cfm/bipartisan_financial_reform_bill_in_us_senate (accessed February 21, 2010).

¹¹See the “Restoring American Financial Stability Act of 2009,” Title X (Consumer Financial Protection Agency), Subtitle F. Section 1061. (b) “(1) BOARD OF GOVERNORS. (A) TRANSFER OF FUNCTIONS. All consumer financial protection functions of the Board of Governors are transferred to the CFPA. (B) BOARD OF GOVERNORS AUTHORITY. The CFPA shall have all powers and duties that were vested in the Board of Governors, relating to consumer financial protection functions, on the day before the designated transfer date.” The text of the Discussion Draft is available on the webpage for the Senate Banking Committee; see http://banking.senate.gov/public/_files/AYO09D44.xml.pdf (p. 1000 of the document, accessed February 21, 2010).

against increases in these fees, and hence the size of aggregate fee revenue can only be so large before it is constrained by political resistance from banks and other fee-payers. Given such a constraint, each agency funded by fees has an incentive to capture the largest portion of the transaction and institution fee base that it can, hence the transfer of Fed funds to the CFPB profoundly affects the Fed even though it does not affect the balance of spending and taxation.¹²

3 Changes in Federal Reserve Speeches, Testimony and Rule-making

An understanding of regulatory behavior – one that incorporates the turf concerns of regulators and their incentives to mute criticism in light of turf threats – would point to a series of threats beginning in March 2009 as a stimulus to regulatory change. In this section and the one following, I provide qualitative and quantitative evidence of significant changes in Fed behavior after the introduction of independent-agency-creating legislation approximately one year ago. My evidence base is simply what the Federal Reserve lists on its website, its speeches, its proposed and finalized rule changes and its announced enforcement actions. My hypothesis is that critical features of these three changed once the threat of an independent consumer agency became tangible in March 2009.

There are obvious limitations to using an agency’s publications (paper or electronic) to track its rhetoric and behavior. For one, much of what regulatory agencies do – in particular one as large as the Federal Reserve – comes in informal activities, negotiations with member banks and regulated entities. These informal communications are a critical part of regulation, and mere examination¹³ . Agency officials may speak to one set of concerns in a public audience, and with another set of concerns to less visible audiences. Published enforcement actions may undercount (or correlate poorly with) the aggregate pattern of regulatory activity undertaken by a government agency.

Despite these limitations, published speeches and activities are especially useful *when it is plausibly the case that reputation-based and audience-based considerations are shaping the organization’s behavior*. To put the matter more simply, what matters in the analysis here is not actual regulatory behavior but demonstrative regulatory behavior. If the two coincide, this suggests that actual pattern of Fed activity are changing in response to turf threats. If the two do not coincide, the analysis is not weakened for the fact, because then the probable explanation is that of “decoupling,” whereby the formal and publicly visible actions of an organization differ from its less visible behavior.¹⁴ Decoupling can occur for reasons both conscious and unconscious, both planned and adaptive. The key is that, whether or not decoupling prevails, examination of announced rhetoric and regulatory activity provides an important window into the turf- and audience-based pressures facing the agency.

In terms of consumer protection, it is important to acknowledge first that major problems began to appear on the regulatory horizon some years ago, well before the financial crisis struck in the fall of 2008. There would appear to be widespread recognition that the Federal Reserve was rather inactive in either advancing consumer protection regulation or regulating the market for mortgages and other home loans in the years before the crisis. As former Fed chairman Paul Volcker said recently, “I don’t think there’s any question the Federal Reserve and other regulators were not on top of the housing picture.”¹⁵ Members of Congress have pointed to the infamous remarks of Board

¹²See “Restoring American Financial Stability Act of 2009,” Sec. 1018, (a)(1)(E)(i) “IN GENERAL.Each year (or quarter of such year), beginning on the designated transfer date, and each quarter thereafter, the Board of Governors shall transfer to the CFPB from the combined earnings of the Federal Reserve System the amount estimated by the CFPB needed to carry out the authorities granted in this title, under the enumerated consumer laws, and transferred under subtitles F and H, taking into account such other sums available to the CFPB for the following year (or quarter of such year), as requested by the CFPB” Text of the Discussion Draft; see http://banking.senate.gov/public/_files/AYO09D44.xml.pdf (p. 881 of draft PDF, accessed February 21, 2010).

¹³See Malcolm Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance*, (Washington, DC: Brookings Institution, 2000); Lars Noah, “Administrative Arm-Twisting in the Shadow of the Congressional Delegations of Authority,” 1997 *Wisconsin Law Review* (1997) 873.

¹⁴The classic argument for decoupling in the face of audience-based pressures appears in John Meyer and Brian Rowan, “Institutionalized Organizations: Formal Structure as Myth and Ceremony,” *American Journal of Sociology* 83 (1977): 340-363.

¹⁵Reuters, Volcker Says Must Let Big Financial Firms Fail, CNBC, February 14, 2010.

officials in July 2000, when Governor Ed Gramlich praised the explosion of subprime lending and appeared to dismiss the abuses as evidenced only by “anecdotal” reports and “TV” news stories; so-called responsible lending advocates had actually produced statistical evidence linking subprime loans to abuses in states like North Carolina.¹⁶ The Federal Reserve failed to act in terms of new rules or new enforcement when foreclosures began to soar in the latter half of 2006,¹⁷ and a similar silence greeted the wave of foreclosures that was observed in the spring and summer of 2007.¹⁸

Only when the agency was confronted with the genuine legislative threat from the House the jeopardy that Congress would transfer its authority to another agency did the Fed respond significantly. Judging from its own statistics and speeches, the Fed has come only recently to the issue of consumer protection, and the shift became especially dramatic when Congress took up the idea of an independent agency, Elizabeth-Warren style. As the financial crisis unfolded in the fall of 2008, Fed officials made a number of remarks about regulation and meeting the needs of the crisis. Yet using what the Fed itself puts on its website, agency leaders (including Bernanke himself) did not begin talking about “consumer protection issues until and March and April of 2009, when an independent consumer financial protection agency was proposed in Congress. In testimony before Congress in September, Bernanke never discussed regulation or consumer protection.¹⁹ Finalization of Regulation C rules was announced, but this merely culminated rulemaking that began in 2004.²⁰ This followed rulemaking that occurred in 2002.²¹ Even in discussing the Fed’s response to rising foreclosure rates and problems in the mortgage market, on December 4, 2008,²² Bernanke never mentioned regulation or consumer protection among the possible policy solutions. Governor Randall Kroszner’s speech on the same day emphasized new policies to combat problems with mortgage-backed securities, including a new infrastructure for regulating them; but no mention was made of consumer finance.²³ Bernanke’s discussions of regulation in January 2009 invariably focused on systemic

http://www.cnn.com/2008/01/16/real.estate/december_foreclosures_up_from_2005/index.htm [accessed February 15, 2010].

¹⁶The hearing transcript at which Gramlich’s remarks appear is available on the FEB’s website. See “Morning Session of Public Hearing on Home Equity Lending, July 27, 2000”; <http://www.federalreserve.gov/events/PublicHearings/20000727/20000727am.htm> (accessed February 21, 2010).

¹⁷see http://money.cnn.com/2007/01/16/real.estate/december_foreclosures_up_from_2005/index.htm (accessed February 1, 2010)

¹⁸see <http://sorendayton.com/2007/08/01/why-foreclosures-matter-the-numbers-are-huge/> (accessed February 1, 2010). According to remarks archived on the Fed website, Governor Randall Kroszner *did* discuss consumer financial protection at several points in 2007 and 2008. In many of these cases, however, the details are more informative than the blunt fact that “consumer protection” was discussed. See for instance Kroszner’s remarks of June 2007, where he warned against regulation and defended the subprime market: “Rising foreclosures in the subprime market over the past year have led the Board to consider whether and how it should use its rulemaking authority to address these concerns. In doing so, however, we must walk a fine line. We must determine how we can help to weed out abuses while also preserving incentives for responsible lenders. *A robust and responsible subprime mortgage market benefits consumers by allowing borrowers with blemished or limited credit histories to become homeowners, access the equity in their homes, or have the flexibility to refinance their loans as needed*” (<http://www.federalreserve.gov/newsevents/speech/kroszner20070614a.htm>; emphasis added). Kroszner’s remarks of November 2007 on “Challenges Facing subprime Borrowers” mentioned the increasing foreclosure rate for subprime borrowers, but nested this discussion within a broader conclusion about the need to preserve financial “spirit of innovation” (last paragraph). Mention was made of rules in the making (these were required by Section 158 of the Home Ownership and Equity Protection Act of 1994 (HOEPA), which requires the Fed to hold public meetings and collect data; so some of these meetings and occasions for rulemaking (all of them before Sept 2008) were instances where Fed officials were speaking to a meeting that would have been held anyway. Even in the 2007 addresses by Kroszner, little if any discussion was given to more vigorous enforcement of the rules (<http://www.federalreserve.gov/newsevents/speech/kroszner20071105a.htm>). Note, finally, that none of these statements in 2007 or 2008 (see footnote below) involved a significant public statement by Chairman Bernanke on the issue of consumer protection.

¹⁹See <http://www.federalreserve.gov/newsevents/testimony/bernanke20080924a.htm> (accessed January 30, 2010).

²⁰See <http://edocket.access.gpo.gov/2008/pdf/E8-25320.pdf> (accessed January 30, 2010).

²¹Consult 67 *Federal Register* 7222 (Feb. 15, 2002); 67 *Federal Register* 30771 (May 8, 2002); and 67 *Federal Register* 43218 (June 27, 2002).

²²See <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm> (accessed January 30, 2010).

²³See <http://www.federalreserve.gov/newsevents/speech/kroszner20081204a.htm> (accessed January 30, 2010). In addition to the remarks in June 2007, which came in a public meeting and proceedings that were required under HOEPA Section 158, Kroszner made remarks in June 2008 on consumer protection, but again the fine print is worth reading, as he emphasizes striking “the right balance between ensuring that consumers receive useful information at an appropriate time and restricting certain practices, while at the same time minimizing the risk of unintended consequences and the imposition of unnecessary costs that could reduce the benefits of a vital con-

regulation, arguing that “we should revisit capital regulations, accounting rules, and other aspects of the regulatory regime to ensure that they do not induce excessive procyclicality in the financial system and the economy.”²⁴ His main policy speech of the following month focused on “programs to strengthen credit markets and the economy.”²⁵

The first comprehensive public statement on consumer protection regulation by top Fed officials in the entire aftermath of the financial crisis did not come until March 19, 2009, when Governor Daniel Tarullo spoke about it at a hearing.²⁶ Bernanke’s speech before the Council on Foreign Relations on March 10, 2009, mentioned only systemic regulation, not consumer-based regulation.²⁷ Bernanke did not mention regulation of consumer products in any speech following the crisis until April 2, right after (and well after) legislative energy for the proposal for consumer protection had begun. His major address on the issue came in mid April 2009, when (again, based on the Fed’s own archive of his speeches) he addressed the issue of “consumer protection for the first time in his response to the financial crisis. The first hint of opposition to the independent agency came in Bernanke’s insistence that it would be his agency that would offer the appropriate response to government failures in financial consumer protection in testimony on July 21, 2009.²⁸ This was followed by Governor Tarullo’s warnings in testimony to the Senate on July 23, 2009.²⁹

4 Policymaking and Enforcement by the Federal Reserve: Regulation as Rhetoric?

Two other areas where the Fed appeared to alter its behavior included rulemaking and enforcement. For a number of reasons, the Board of Governors had been altering rules related to mortgages since 2008. That year, using its authority under the Truth in Lending Act (TILA), the Fed announced revisions to “Regulation Z” in July.³⁰ The new rules imposed significant constraints on sub-prime mortgage lending and similar activities, though many observers wondered why they did not come years earlier, and other critics wondered why the mortgage lending industry was given over 14 months to comply with the rules, especially given that the national housing crisis was spiraling out

sumer finance marketplace” (<http://www.federalreserve.gov/newsevents/speech/kroszner20080611a.htm>). *Notice the absence of these worries about regulatory overreaction and defense of the “responsible” subprime lending market after March 2009, when the CFPA was introduced.* A little over a month later, Kroszner gave remarks at a conference on Minority-Owned Institutions and Consumer Protection” in Chicago, where he outlined the Fed’s response to HOEPA (<http://www.federalreserve.gov/newsevents/speech/kroszner20080717a.htm>). As with other speeches made by Kroszner in 2007 and 2008, these remarks came at pre-scheduled events; it is questionable whether they should be interpreted as initiatives toward more aggressive consumer protection.

²⁴<http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm> (accessed January 30, 2010).

²⁵See <http://www.federalreserve.gov/newsevents/testimony/bernanke20090210a.htm> (accessed January 30, 2010).

²⁶Consult Tarullo’s speech at <http://www.federalreserve.gov/newsevents/testimony/tarullo20090319a.htm> (accessed January 30, 2010). This statement again focuses only upon publicly archived speeches and testimony at the Federal Reserve Board’s website; I cannot rule out that before Tarullo’s speech of March 19, 2009, Fed officials made remarks that are not archived on the Board’s website or that they made informal remarks at press conferences or other settings in response to questions. Still, if such remarks occurred, it would seem incredibly odd – and perhaps telling of its officials’ intentions and demonstrative regulation to different audiences – that they were not matched by remarks listed publicly.

The closest any Fed official came to a pronouncement about consumer protection came in remarks on March 11, 2009, by Sandra F. Braunstein, Director, Division of Consumer and Community Affairs. Braunstein spoke on “Mortgage lending reform” before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives; see <http://www.federalreserve.gov/newsevents/testimony/braunstein20090311a.htm>. These were not the remarks of a Governor, however, and even these remarks came after it was well known that a CFPA was a real legislative threat to the Fed.

²⁷This speech is available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm> (accessed January 30, 2010).

²⁸See <http://www.federalreserve.gov/newsevents/testimony/bernanke20090721a.htm>

²⁹Consult Tarullo’s speech at <http://www.federalreserve.gov/newsevents/testimony/tarullo20090723a.htm>.

³⁰See the announcement and associated documentation at <http://federalreserve.gov/newsevents/press/bcreg/20080714a.htm> (accessed February 21, 2010).

of control at the time.³¹ In March 2009, the Fed also announced revisions to its rules for educational loans.³²

Two days after Bernanke defended his institution before Congress on July 21, and the very day that Governor Tarullo warned Congress about the costs of transferring these important responsibilities to another agency (or any agency not under the Fed's penumbra), the Fed announced the first in a set of critical proposed rules changes, to Rule Z for mortgage disclosures.³³ Two months later, as the House began to take up the independent agency proposal in committee, the Fed proposed that credit cards should be subject to similar regulatory reforms,³⁴ and Bernanke followed on the 1st of October with a proposal that Congress create a council of risk regulators. This proposal, which would have the effect of retaining the status quo regulators for systemic and possibly consumer finance, echoed a plan for a council of consumer protection regulators that was then under consideration in the House, proposed by Idaho Democrat Walt Minnick. The House later defeated the Minnick plan and passed a financial regulatory reform bill that established the CFPB.

In July 2009, when the second (and more significant and noteworthy) set of revisions to Regulation Z were proposed, observers of financial markets and financial regulation noted two things. First, there was widespread understanding that the July 2009 proposals were significant and would, if enacted, impose appreciable costs upon banks and consumer lenders.³⁵ Second, observers have noted the clear correspondence of these rules to the turf threat posed by a CFPB. As contributors for the financial website *fxstreet.com* stated in an interpretation of the July 2009 proposed rules, "Bottom line: The proposed changes are in line with suggested reforms within the legislative process regarding the Consumer Financial Protection Agency (CFPA). The Federal Reserve may no longer regulate consumer financial products under certain iterations of the legislation backing the CFPB. Today's announcement is part of the feedback loop regarding this pending legislation and implications for the Federal Reserve's structure."³⁶

³¹Bob Tedeschi, "New Lending Rules Coming Soon," *The New York Times* September 25, 2009; <http://www.nytimes.com/2009/09/27/realestate/27mort.html> (accessed February 21, 2010).

³²These rules were authorized by the Higher Education Opportunity Act (HEOA), which was signed into law on August 14, 2008; the new rules were not announced until <http://www.federalreserve.gov/newsevents/press/bcreg/20090311a.htm> (accessed February 21, 2010).

³³The announcement and the rules are available at <http://www.federalreserve.gov/newsevents/press/bcreg/20090723a.htm> (accessed January 30, 2010). There was of course move in July 2008 to revise Regulation Z (which by critics' accounts came years too late), but the July 2009 move was in addition to that of a year before, was considered more "disruptive" to the status quo, and was widely interpreted as symbolic. *Notice that Bernanke releases a statement about the July 2009 rules* (<http://www.federalreserve.gov/newsevents/press/bcreg/bernanke20090723a.htm>) *that is much more elaborate than the brief introduction he makes for the July 2008 rules* (<http://federalreserve.gov/newsevents/press/bcreg/bernanke20080714.htm>).

³⁴See <http://www.federalreserve.gov/newsevents/press/bcreg/20090929a.htm> (accessed January 30, 2010). It is of course true that these rules revised a draft of December 2008 and also implemented mandates in the Credit Card Accountability Responsibility and Disclosure Act of 2009. There was also a disproportionate gap between the vigor of the announcement (and its coverage in the news media) and the enforcement plan of the Fed, which in December 2008 gave banks 18 months with which to comply with the new rules. Connie Prater, "Regulators finalize sweeping credit card rule reforms: Consumer groups pleased, but not with the 18-month phase-in," *Credit Cards.com*, at <http://www.creditcards.com/credit-card-news/fed-enacts-new-credit-card-regulations-1282.php> (accessed March 16, 2010).

³⁵The Consumer Bankers' Association (CBA) sounded the first alarm: "Today, the Federal Reserve Board issued two proposals to amend Regulation Z, which implements the Truth in Lending Act (TILA). One addresses closed end mortgages and the other home equity lines of credit (HELOCs). These changes, if adopted, will profoundly transform the timing, format and content of disclosures for all real estate-secured lending to consumers." Consumer Bankers' Association, "Fed Proposes Major TILA Changes for Mortgages and Home Equity Lines," *CBA Bankalert*, July 23, 2009; <http://www.cbaret.org/files/FileDownloads/Mortgage-HELOC.pdf> (accessed January 23, 2010).

³⁶The BBVN report appears at <http://www.fxstreet.com/fundamental/economic-indicators/us-fed-revises-regulation-z/2009-07-24.html> (accessed February 21, 2010). Even analysts skeptical of the CFPB have noticed that federal agencies have shifted their behavior in regards to threats or expectations of more stringent oversight from the Obama Administration. John I. Vong and Gerald C. Lampe, "Mortgage Mash-Up: Regulatory Reform Here and Now," *Mortgage Banker* January 2010 "Not to be outdone, another federal agency, the Federal Trade Commission (FTC), recently exercised its authority over unfair trade practices in the mortgage lending space, particularly against mortgage servicers. This was not without prompting from lawmakers, of course. Congress directed the FTC, in the Omnibus Appropriations Act signed by President Obama on March 11, 2009, to issue its own rules governing mortgage loans." See the report at <http://www.compliancease.com/opencms/opencms/CEContent/docs/articles/1-10-Mortgage-Banking-regulatory-reform-here-and-now.pdf> (accessed February 21, 2010).

5 Changes in Federal Reserve Announced Enforcement Actions

In its speeches and in its new rules, then, there is plausible reason to believe that shifts in regulatory emphasis and substance at the Federal Reserve were associated with the emergence of a genuine threat to the organization’s statutory authority and fiscal and human resources. The timing of the FRB’s response in regulation and rhetoric seems to gesture to March 2009 as a shifting juncture. Just as important, the substance of the changes to FRB speeches was on the subject of precisely the topic for which the agency was getting severely criticized, and on which the proposed agency would exercise the core of its mission. The new rules, too, aimed to achieve in FRB rulemaking a significant part of what would be expected to come from the independent agency if it were created in law.³⁷

In this section, I adduce evidence from a time series of announced enforcement actions by the Fed over the past thirteen years. For each month from January 1998 to the present, I aggregate the total number of enforcement actions announced by the Federal Reserve on the enforcement section of its website. The time series so aggregated becomes the dependent variable for analysis.³⁸ A plot of the enforcement aggregates over time appears in Figure 1.

For the time-series of enforcement counts, I estimate the following two linear models, using the negative binomial distribution to map predictions from the linear battery of covariates (each parameterized by a scalar β , with the main variables of interest parameterized by γ) to the enforcement variable. The first model is:

$$\text{ENFORCEMENT}_t = f_{\text{NB}}\{\beta_0 + \beta_1 \text{YEAR}_t + \beta_2 \text{MARCH}_t + \beta_3 \Delta(\text{HOUSING STARTS})_t + \beta_4 \% \Delta(\text{HOUSING PRICES})_t + \beta_5 \% \Delta(\text{IND. PRODUCTION INDEX})_t + \beta_6 (\text{AFTER 2006})_t + \gamma_1 (\text{FINANCIAL CRISIS})_t + \gamma_2 (\text{CFPA PROPOSAL})_t + \epsilon_t\}$$

In this model, YEAR is a trend control, and MARCH denotes a binary variable scored 1 in March (to capture seasonal trends that may confound inference from the March 2009).³⁹ The variables $\Delta(\text{HOUSING STARTS})_t$, $\% \Delta(\text{HOUSING PRICES})_t$ and $\% \Delta(\text{INDUSTRIAL PRODUCTION INDEX})_t$ are monthly measurements of changes in national housing starts, median nationwide housing price (percentagized change), and the industrial production index (percentagized change), to measure month-to-month changes in economic and housing fundamentals that may shift enforcement actions.⁴⁰ From the model estimates, marginal effects (expected change for the enforcement counts for each one-unit shift in the relevant independent variable, holding all other variables at their means) are calculated and will be reported separately.

The logic of the first model is that the central variables $(\text{FINANCIAL CRISIS})_t$ and $(\text{CFPA PROPOSAL})_t$ are ‘permanent’ shifts to the enforcement aggregates, such that the financial crisis of September 2008

³⁷I acknowledge that I am hardly the first person to suggest this point. See most recently the reporting of Sewell Chan in the *New York Times*, including this bit from his piece on the Corker provision regarding payday loans: “Mr. Bernanke, who had met with the group twice before, is trying to fend off proposals in the Senate to strip the Fed of much of its power to supervise banks. A recommitment to protection [of] consumers is part of that strategy” (<http://www.nytimes.com/2010/03/10/business/10regulate.html?dbk>).

³⁸The list of enforcement actions for the calendar year 2009 appears at <http://www.federalreserve.gov/newsevents/press/enforcement/2009enforcement.htm> (accessed January 25, 2010). For each of these pages, and for each of the months during the calendar year represented, I tallied the number of enforcement actions listed; each of the actions corresponds to a single web entry on the page. The resulting time-series is monthly data covering January 1998 through January 2010, where for each month the dependent variable for count regressions is the number of announced actions for the month in question.

³⁹It is also possible to include the trend measured by month (a simple time-series ‘counter’) and/or to ; neither of these makes a material difference in the estimates.

⁴⁰The data on housing starts and industrial production come from the monthly time-series of the St. Louis Federal Research Bank; see <http://research.stlouisfed.org/fred2/series/HOUST/downloaddata?cid=97> and <http://research.stlouisfed.org/fred2/series/INDPRO/downloaddata?cid=3>, respectively (accessed February 3, 2010). The data on housing prices is from the Federal Housing finance Agency (FHFA) at <http://www.fhfa.gov/Default.aspx?Page=87> (accessed February 5, 2010). It is possible to use housing starts and housing prices in particular regions that were particularly affected by the foreclosure crisis (such as the mountain West or the Pacific region), and I have done so, but these produce neither significant coefficient estimates nor material changes to other estimates in the model.

and the CFPA proposal of March 2009 are coded as 1 in the . The model is therefore *not* autoregressive. A second model introduces an autoregressive term and then shifts the major intervention to six-month ‘boost’, after which the variable reverts to zero. This model is:

$$\text{ENFORCEMENT}_t = f_{\text{NB}}\{\delta\text{ENFORCEMENT}_{t-1} + \beta_0 + \beta_1\text{YEAR}_t + \beta_2\text{MARCH}_t + \beta_3\Delta(\text{HOUSING STARTS})_t + \beta_4\%\Delta(\text{HOUSING PRICES})_t + \beta_5\%\Delta(\text{IND. PRODUCTION INDEX})_t + \beta_6(\text{AFTER 2006})_t + \gamma_3(\text{FINANCIAL CRISIS 6 MONTHS})_t + \gamma_4(\text{CFPA PROPOSAL 6 MONTHS})_t + \epsilon_t\}$$

Results of model estimation appear in Table 1, with marginal effects estimates in Table 2, and graphical depiction of the time-series and shifts appear in Figures 1 and 2.

The estimates in Table 1 suggest that recent events have been associated with durable shifts in the Federal Reserve’s announced enforcement activities. Each coefficient estimate represents the shift in the negative binomial regression function for a one-unit change in the independent variable. There would appear to be a statistically significant trend over time and an increase in the month of March. When the financial crisis and the introduction of the CFPA bill are represented as permanent shifts (model 1 in the leftmost column of estimates), each is associated with a statistically significant increase in the rate of announced enforcement actions. There is not, however, a statistically detectable increase beginning in 2007 when the rate of foreclosures began to skyrocket; indeed, the model estimate on $(\text{AFTER 2006})_t$ is negative, though statistically non-differentiable from zero.

When the autoregressive model is estimated (models 2a and 2b), and when the financial crisis onset and the CFPA bill are represented as six-month boosts, the explanatory power of the financial crisis (or related event beginning in September 2008) wanes considerably. The coefficient estimate is cut by 80 percent, and the estimate is no longer differentiable from zero. The estimate on the CFPA bill introduction rises slightly, however, and if the unstable variable after 2006 is dropped, the size of the CFPA bill variable increases appreciably.

The marginal effects estimates from the model estimated in Table 1 (Figure 1) appear in Table 2 (Figure 2). The over time trend from 1997 to the present suggests that for each year, 0.14 additional enforcement actions were taken. These actions would appear to be higher in the month of March by two to two-and-a-half announcements. An increase in housing start of one million would appear to be associated with five additional monthly; this is, however, difficult to interpret causally. When the financial crisis onset and the CFPA bill are represented as permanent shifts, then the crisis onset is associated with a 5.5-unit increase in the number of announced enforcement actions, while the CFPA bill introduction, net of the financial crisis, is associated with 2.3 additional enforcement actions per month. When these interventions are represented as six-month boosts, however, the picture changes considerably. The crisis onset in September 2008 is associated with a statistically meaningless 1.2 to 1.5 increase in monthly announced enforcement actions, while the CFPA bill’s introduction in March 2009 is associated with a 2.6- to 3.2-unit increase in announcements. By reference, the associated increase for the CFPA bill’s introduction ranges from 70 percent to 90 percent of the mean value of the predicted series, which is consistent with (albeit slightly below) the near-doubling observed in the graphical time-series below.

Table 1. Model Estimates from Negative Binomial Regression Analysis of FRB Announced Enforcement			
	1	2a	2b
ENFORCEMENT (lagged)	-----	0.08 (0.01)	0.09 (0.01)
YEAR	0.04 (0.02)	-----	-----
MONTH OF MARCH	0.51 (0.14)	0.59 (0.17)	0.60 (0.17)
Change in Housing Starts (millions)	1.08 (0.47)	1.49 (0.55)	1.57 (0.12)
Percentage Change in Housing Prices	0.15 (0.11)	0.04 (0.13)	0.19 (0.11)
Percentage Change in Industrial Production Index	9.36 (5.59)	5.67 (7.41)	5.17 (7.62)
After 2006	-0.13 (0.20)	0.35 (0.18)	-----
Financial Crisis (after August 2008)	1.01 (0.21)	0.29 (0.23)	0.36 (0.24)
CFPA Proposal (March 2009 and after)	0.53 (0.20)	0.57 (0.26)	0.66 (0.27)
N	154	154	154
Log-Likelihood	-320.26	-330.75	-332.66

Figure 1: Negative Binomial Regression Estimates for Monthly FRB Enforcement, 1997-2010

Table 2. Marginal Effects Estimates from Negative Binomial Regression Analysis of FRB Announced Enforcement			
	1	2a	2b
ENFORCEMENT (lagged)	-----	0.29 (0.05)	0.33 (0.05)
YEAR	0.14 (0.07)	-----	-----
MONTH OF MARCH	2.21 (0.75)	2.68 (0.98)	2.77 (1.02)
Change in Housing Starts (millions)	3.75 (1.62)	5.23 (1.92)	5.52 (1.97)
Percentage Change in Housing Prices	0.52 (0.37)	0.15 (0.47)	0.67 (0.41)
Percentage Change in Industrial Production Index	32.54 (19.39)	19.85 (25.96)	18.21 (26.82)
After 2006	-0.43 (0.64)	1.36 (0.75)	-----
Financial Crisis (after August 2008)	5.49 (1.66)	1.18 (1.06)	1.51 (1.17)
CFPA Proposal (March 2009 and after)	2.34 (1.10)	2.64 (1.55)	3.19 (1.10)
N	154	154	154
Predicted Events per Month	3.47	3.50	3.52

Figure 2: Marginal Effects from Negative Binomial Estimates: FRB Enforcement, 1997-2010

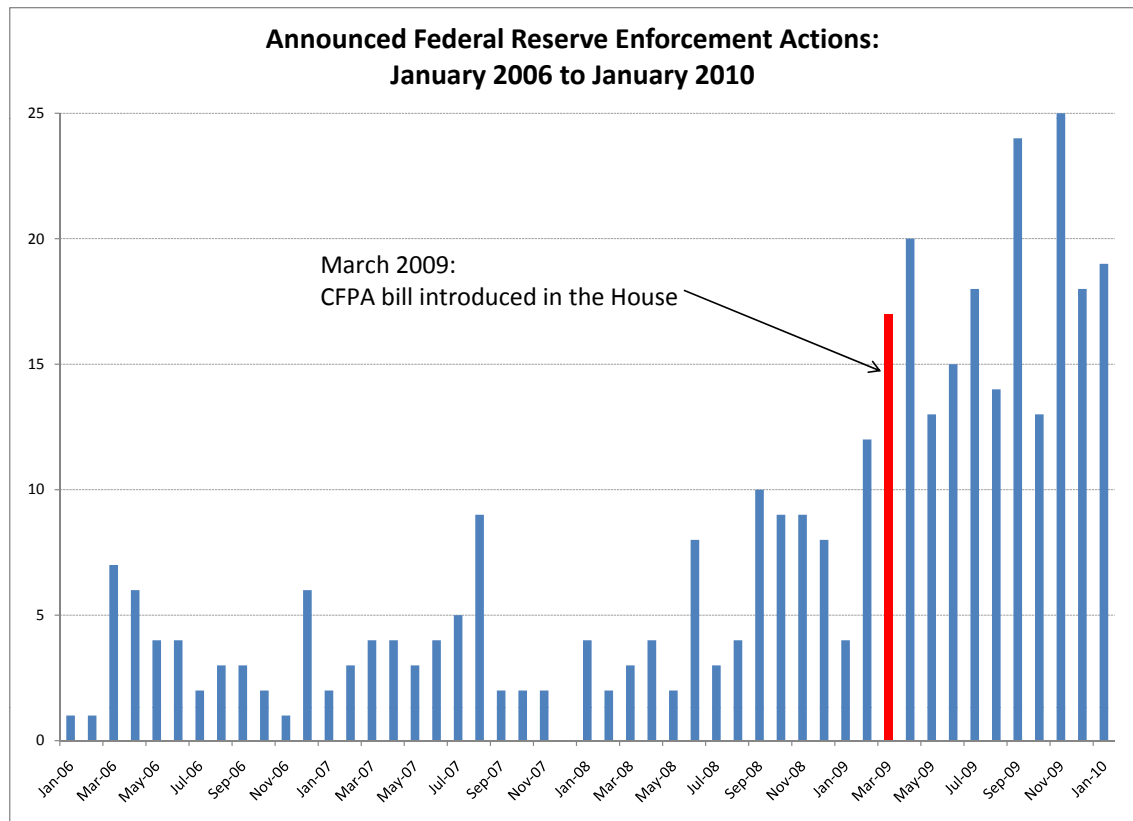


Figure 3: Time-series of FRB announced enforcement patterns, 2006-2010

The raw values of the time-series of Federal Reserve announced enforcement actions appear in Figure 3. The month of March 2009 is coded in red, and it is observed that the enforcement series reaches unprecedented heights after the CFPA bill's introduction, and these aggregate levels never return below the level of February 2009, or the month before the CFPA bill's introduction to the House.

It is possible, of course, that some of the FRB announcements were planned before the months in which they occur (though in general, federal agencies have considerable discretion and leeway in announcing and timing their enforcement activity). Yet if so, it is just as likely that the Fed saw the CFPA threat coming ahead of time, and that some of the increased enforcement activity in the fall of 2008 may be viewed as an attempt by the FRB to shore up its bank-policing reputation in an effort to fend off or dilute reform.

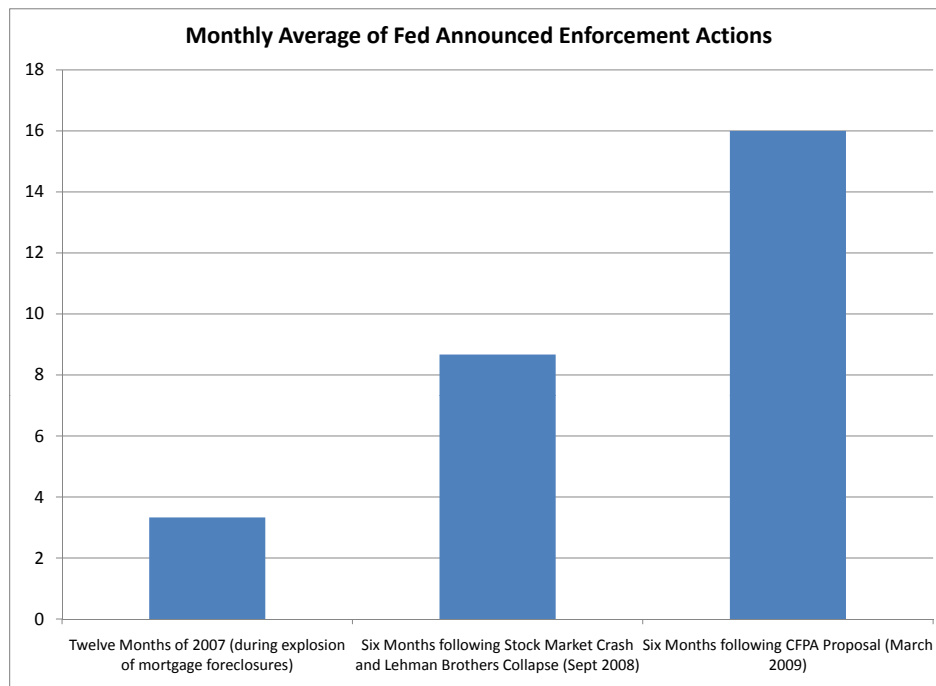


Figure 4: Figure 4: Six-month averages in enforcement following financial crisis onset and CFPB bill introduction

The six-month boosts are shown as averages in Figure 4. From this evidence, it would appear that March 2009 shifts in the Fed’s rhetoric were accompanied by an appreciable change in announced enforcement by the Federal Reserve. Again, using data listed on the Board’s website, announced enforcement actions against banks and lenders came at a snail’s pace (just over three per month) during the very time that active foreclosures were hitting one million in statistical reports. Only when the crisis passed “from Main Street to Wall Street,” in September 2008, did Fed enforcement activity (again, its own announcements) surge (to about eight and a half per month). But the Fed’s announcements on its enforcement activity reached new (and unprecedented) heights when Congress took up the idea of an independent regulator in March 2009. From a post-crisis average of eight announced enforcement actions per month, the Fed nearly doubled its announcements to sixteen actions per month. Every other day, or three out of four business days per week, the Fed was publicly announcing a new enforcement action.

6 Conclusion: Is the Threat Credible? And Who Regulates the Financial Regulators?

What sense can we make from these patterns?

If it is true that the more aggressive posture of existing regulators has come wholly or largely in response to the threat that congress would create a new and independent agency, then the counterfactual follows: once the threat is removed (by Congress dropping the bill, by a change in the ideological or partisan composition of congress or, just as important, the relevant finance and banking committees), the new pattern of regulation will be formally or informally abandoned. This is of course a prediction and it will depend on the hypothesis (the passage or failure of a CFPA) coming true.

It is, of course, difficult if not impossible to establish causality in observational data. Both narratively and statistically, I am able to present only associations, not causal effects estimates. I am generally skeptical of the existence of informative “natural experiments” in the social sciences – “Freakonomics” should always be viewed with caution if not disbelief altogether – though perhaps the threat of a CFPA does function as a form of quasi-experiment. Nonetheless, it is impossible in a case such as this to make a fully valid causal inference, to say as we might with a randomized controlled trial in medicine that the CFPA bill’s introduction caused a change in Fed rulemaking or enforcement activity.

From the standpoint of what political scientists and other scholars of bureaucracy have learned in the last half-century, the Fed’s response to the threat of an independent agency is not surprising. Political scientists have documented for nearly a century how agencies try to fend off incursions on their turf, and how they adapt their behavior to mollify the public and Congress. What is surprising, and perhaps troubling, is the inconsistent response of politicians, especially those in the Senate, to this crisis and the Fed’s response. Senator after Senator on both sides of the partisan aisle has said that they want to avoid restricting credit. Senate Republican Richard Shelby called the agency “a folly and dangerous.” Senate Democrats Tim Johnson and Mark Warner have both raised concerns about the possibility that a CFPA could restrict access to credit. Yet there is no denying that, if robustly enforced, some of the Fed’s new rules will indeed restrict credit. Nor is there any denying that the Fed has been proposing some of the same regulations that would have been carried out by an independent regulator if it were established. The Wall Street Journal called them “sweeping new consumer protections for mortgages and home-equity loans” when they were unveiled in July of 2009.⁴¹ The new rules compelled simplified disclosures for mortgage costs and amortization terms; they effectively banned yield spread premiums; they directed lenders to create one-page documents demonstrating the risks of loans to consumers; they forced lenders to show consumers how their rate compares with rates of borrowers with better credit.

This leaves, then, several puzzles. If Senators Johnson, Warner and others (including Shelby) are so concerned about restricting access to credit, then where were their laments when the Fed’s new rules were proposed? More generally, is regulation by the Fed, whose primary mission is monetary policy and stabilization, more democratically accountable than regulation by a new agency would be? The statistics and narrative presented here suggest that, if anything, regulation by a new agency is likely to be no more unstable. In our regulatory status quo, what is the mapping from the recognition or anticipation of problems to the provision of solutions? Is that mapping close to optimal? That is the question that policymakers should be concerned with, and more studies of the rulemaking and enforcement patterns of banking regulators are needed to address this question.

Another question is whether any sort of new agency is needed if the FRB and other agencies like the Federal Trade Commission have already been responding. This is the argument that Federal Reserve officials have been making. The problem, of course, is that in order for regulation to be responsive in the long-term, the threat of authority transfer must be a real one. If the shifts in regulation and rulemaking at the Fed and other agencies had come largely in response to the financial crisis, then President Obama, members of Congress and American citizens might be persuaded that

⁴¹The *Journal’s* judgment appears at <http://online.wsj.com/article/SB124837547483376651.html> (accessed February 6, 2010).

federal financial agencies are operating with a new regulatory understanding. Yet the analysis here suggests, at least initially, that most of the Federal Reserve's response has been to the threat of an independent agency, not the underlying housing crisis itself (or associated debt crisis linked to securitization), and not the larger financial crisis that broke open in the fall of 2008. If this finding is true, then the turf and reputation incentives for the Fed and other banking regulators point in a different direction, and there is much less reason to believe that the new regulation will stick, either on parchment or as enforced.

Finally, a note about Senator Dodd's proposal of March 15, 2010.⁴² In theory, Dodd's proposal leaves the consumer agency within the Federal Reserve but "autonomous" (see the various subheadings in Title X where this aspect of the agency seems to be highlighted). But on this point, it is questionable whether the Fed can really commit to keeping its hands off of the consumer bureau. Consider again the reputational incentives. If the Fed's leadership would rather claim credit for consumer protection, or if it fears that an aggressive consumer rule will get in the way of its prudential regulation or the profitability of financial institutions, it may well try to tamp down on the agency by pressuring its oversight council, throwing procedural roadblocks in the way of consumer protection rules, or try some other obstructionist measure. Rather uniquely among regulatory agencies, the consumer bureau will have its rules reviewed by other financial regulators.⁴³

And, finally, one wonders about the long-term signal sent to regulators in the future. By most accounts, the Federal Reserve erred significantly in the lead-up to our crisis. Yet under Dodd's bill, that very institution now stands to gain a new bureau and new authority. What will happen to the new consumer bureau if it commits a regulatory snafu? Will it, too, see a further windfall in the aftermath of failure?

⁴²I will develop more thoughts about this proposal as its parameters and implications become clearer to me.

⁴³Since President Reagan's Executive Order 12291, regulatory agencies have had their proposed rules examined continually by the Office of Management and Budget (OMB), which is technically an extension of the President himself. But having the rules reviewed by other congressionally created entities is quite another matter.