Statement before the Committee on Financial Services
U.S. House of Representatives
On Restructuring Consumer Financial Products Regulation

One Good Idea and a Number of Bad Ones

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June 24, 2009

Mr. Chairman, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I spent 35 years in banking, including twelve years as President and CEO of the Federal Home Loan Bank of Chicago. I have experienced and studied many cycles of financial bubbles and busts, including the political reactions, and overreactions, which inevitably follow. It appears to me that the proposals we are considering represent the normal political reaction phase.

The Proposed "Consumer Financial Protection Agency"

I think we can all agree as a matter of objective interpretation that the "CFPA" as proposed would be a highly intrusive, large, very expensive bureaucracy, with broad, rather undefined, and potentially arbitrary powers, which would impose large costs on consumer financial services, while also imposing requirements which would be likely to conflict with those of other regulatory agencies. Where we differ is that some of us like the idea of having such a bureaucracy, and some of us, including me, do not.

According to the Administration's White Paper on regulatory restructuring, the proposed CFPA would not only "define standards for 'plain vanilla' products"—that is, define products—but would "be authorized to require all providers and intermediaries to offer these products." All "providers and intermediaries"—a vast jurisdiction apparently unrelated to any chartering definitions—would have part of their business dictated by this agency. That is a truly amazing assertion.

Moreover, CFPA should "be authorized to place tailored restrictions"—that is, restrictions—"on product terms and provider practices." "Terms" presumably includes pricing. Does it include credit standards, such as required down payments?

A more sensible proposal would have been to define certain financial products as "plain vanilla," and require disclosure that "This is—or is not—a plain vanilla financial product suitable for an unsophisticated customer." But this idea, which strikes me as reasonable, would not require a new agency. I will discuss disclosures more in a moment.

The CFPA is to have "sole" authority, for example, to define the meaning of "reasonable." This is by no means an easy legal or philosophical project. It would also have supervisory, examination, and "a full range of enforcement powers." For financial institutions, it would be an additional, parallel regulatory system representing a major burden, a potentially punitive approach, and significant regulatory risk; this is likely to be quite at odds with the intense desire of the government to attract additional capital into the banking system.

Community Banks

The first major regulatory overreaction of the 21st century, the Sarbanes-Oxley Act, proved highly successful at generating cost and bureaucracy, while apparently having no influence at impeding the buildup of risk. For large companies, it was proportionately less of a problem, since they simply created internal corporate bureaucracies to deal with its demands. But it created, and still creates, disproportionate burdens on small and venture businesses.

I believe we would see a similar pattern for a CFPA—large financial companies would respond in the same way as they did for Sarbanes-Oxley, and small ones would be disproportionately burdened.

Community banks had and have little to do with the issues of the complex mortgages and mortgage securities which led to the panic and bust. Should Congress ever proceed with a CFPA, it would be reasonable to exempt all community financial institutions.

One Good Idea: Clear, Simple Disclosures

The Administration's proposal emphasizes one very good idea: insuring clear, simple, straightforward, informative disclosures. Of course, we do not need a CFPA to achieve this.

In Congressional testimony in the spring of 2007, I proposed a one-page mortgage form so borrowers could easily focus on what they really need to know. The one-page form idea was included in bills in both the House and Senate, but not enacted, unfortunately. It remains my opinion that something like it would be a huge improvement in the way the American mortgage system works.

Subsequently, at the request of a member of Congress, I designed a one-page overdraft form. It seems to me that this approach would be valuable in consumer financial services generally, but it is most important for mortgages, because that is by far the largest debt and financial commitment for most households.

By far the most important use of mortgage disclosures is for borrowers to be able to underwrite themselves—that is, to decide whether they can afford the debt service commitments they are making. In the ideal case, the borrowers would be able to correctly complete the one-page form themselves.

In my view, the indubitably best consumer protection is the ability to exercise personal responsibility in making informed decisions about underwriting yourself for the credit and about how much risk you wish to take. This is the best reason to have clear and straightforward disclosures: not just to get understandable information, but to act on it. This is why I believe, by the way, that it is essential to have the one-page form, or any variation of it, include the signature of the borrowers.

A Missing Idea: Personal Responsibility

With this as context, it seems remarkable to me that the idea of enabling and building personal responsibility on the part of consumers does not seem to appear anywhere in the

Administration's proposal. One of my friends did a computer search of the White Paper for the term "personal responsibility" and got zero hits.

Another Missing Idea: Fannie and Freddie

While looking to restructure regulation of the entire financial system, the Administration's White Paper gets to Fannie Mae and Freddie Mac and loses its courage, merely concluding that they need to be studied further.

But it is impossible to address the issues of the mortgage finance system, or indeed the problems of the bubble and bust, or the problems of defaulted nonprime mortgage borrowers, without addressing Fannie and Freddie. As everybody knows, they represent a vast half of all outstanding residential mortgage credit; they made a huge contribution to inflating the mortgage bubble; they plunged into low quality mortgage credit and pushed the top higher; they accumulated hundreds of billions of dollars of subprime and nonprime mortgages, the defaults on which have driven them into insolvency. Fannie and Freddie's operations dominate and shape the mortgage market—now more than ever, ironically.

What is the relationship of Fannie and Freddie to the CFPA proposed to be? Without addressing this issue, the proposal leaves a central issue of the mortgage market unanswered.

A Bad Idea: CRA in the CFPA

The CFPA is proposed to have "sole authority to evaluate institutions under the CRA" and to "promote community development investment," taking these responsibilities away from the existing regulators. I believe this is a truly bad idea.

The proposal believes that there is a "conflict" between CRA and safety and soundness responsibilities. On the contrary, I believe that whenever credit risk and investment risk are involved, it is absolutely necessary to have to balance between "community investment" and safety and soundness. Thus, it is imperative for such responsibilities to be combined in one regulatory agency. The alternative, to have credit and investment being "promoted" by people with no responsibility for safety and soundness, appears to me worse than dubious.

Conflict Among Regulators

Moreover, the preceding issue points out an obvious question: What happens when the safety and soundness regulator disagrees with the CFPA? It seems to me such disagreements are inevitable. The question is simply unaddressed in the proposal.

Sitting, as we are, in the wake of a credit collapse, it should be readily concluded that the superior authority should be placed with responsibility for safety and soundness.

A more straightforward solution to this issue, if one wants to keep the idea of centralizing consumer protection and disclosure responsibilities, is to make use of a logical existing organization, and just drop the notion of the CFPA. My suggestion would be to use the Federal Reserve. It seems to me the Fed is highly qualified for this responsibility.

Attracting Capital

As a final thought, I would like to repeat that any proposals which substantially increase regulatory burden and regulatory risk must be considered in the light of the government's intense need to attract very large amounts of additional private equity capital into the banking system.

Thank you again for the chance to share these views. It would be a pleasure to address any questions on these or other aspects of the Administration's proposal, such as the "systemic risk regulator."