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# The Consumer Financial Protection Bureau: A Five-Year Retrospective

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# The Consumer Financial Protection Bureau: A Five-Year Retrospective

## **Cover Page Footnote**

Robert E. Krainer, *The Consumer Financial Protection Bureau: A Five-Year Retrospective*, 10 U. St. Thomas J.L. & Pub. Pol'y 17 (2015).

# THE CONSUMER FINANCIAL PROTECTION BUREAU: A FIVE-YEAR RETROSPECTIVE<sup>1</sup>

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## INTRODUCTION

July 21, 2015 marked the fifth anniversary of the passing into law of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).<sup>2</sup> Dodd-Frank is a roughly 2,300 page document and its complicated rules and regulations are still in the process of being formulated and implemented. In this paper I will primarily concern myself with Title X of the Act, namely, The Consumer Financial Protection Bureau (“CFPB”)<sup>3</sup> focusing attention on certain aspects of the home mortgage market. More generally, we want to know whether Dodd-Frank and the CFPB have furthered the goals of government policy. In a broad sense the answer must be: no. The answer is no because there is a stark contradiction between the goals of the CFPB and the other parts of Dodd-Frank. Superimposed on both is a social policy going back to the 1930’s whose goal is to promote home ownership and access to financial products for all income groups including low-income households. The goal of the CFPB is to protect consumers while the rest of Dodd-Frank is designed to stabilize the financial system. As we will see below, both are in conflict with each other and the social goal of subsidizing housing and access to financial products for low-income families. What makes this a particularly dangerous contradiction is that all three goals are designed to be attained within the private financial sector. We question the wisdom of running welfare programs through the private financial system, the system that broke down in 2007-2008. In Section IV, we sketch out a program on how the

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1. A paper presented at the 2015 fall symposium on Law and Public Policy at the School of Law at Saint Thomas University and forthcoming in the *Journal of Law and Public Policy*.

2. Victor McGrane and Andrew Ackerman, *Five Years Later, Dodd Frank Creators Say the American Banking System is Better Off*, WALL ST. J., July 19, 2015.

3. Legal Information Institute, Cornell University Law School, Dodd-Frank: Title X-Bureau of Consumer Financial Protection, [https://www.law.cornell.edu/wex/dodd-frank\\_title\\_X](https://www.law.cornell.edu/wex/dodd-frank_title_X).

government might possibly sidestep this contradiction.

In evaluating the CFPB we begin in Section II by briefly describing the economic events that gave rise to Dodd-Frank. That economic background was the Great Financial and Economic Crisis that began in 2007. This crisis was different. It was more severe than any recession since the Great Depression. It also illustrated some of the most egregious practices that characterizes the financial system in a competitive capitalist system. In Section III, we describe the salient features of the regulatory response to the Great Crisis, focusing mainly on the CFPB regulation of home mortgages. We then present a five-year evaluation of the CFPB in Section IV. Section V concludes with a brief summary and a suggestion for a different approach to achieving financial stability along with a government program encouraging home ownership for all income classes.

## THE GREAT CRISIS

### I. THE ECONOMIC BACKGROUND

The financial and subsequent economic crisis that started in 2007 was the worst experienced by the United States since the Great Depression in the 1930's. Figure 1 compares the 2007–2009 recession to the previous five recessions.<sup>4</sup> There it can be seen that the 2007–2009 recession was both deeper and of a longer duration than any of the five previous recessions. According to Treasury Department estimates, 8.8 million jobs were lost as of 2012.<sup>5</sup> The unemployment rate reached 10 percent in 2009, and the civilian labor force participation rate fell from 64.4 percent in 2000 to 58.4 percent in 2011. People gave up looking for jobs. The cumulative cost from Figure 2 in terms of lost real Gross Domestic Product (“GDP”) ranged from \$6 trillion to \$14 trillion (so far) or \$50,000 to \$120,000 per household, depending on assumptions regarding the long-run trend in real GDP after the crisis.<sup>6</sup> Over the 2007–2011 period household net worth in housing assets fell 33 percent, and stock market valuations fell 40 percent between October 2007 and June 2009. According to U.S. Department of Treasury estimates, total household wealth fell \$19.2 trillion over this period.<sup>7</sup> Finally, the Great Crisis was not limited to the United States. As Figure 3

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4. See The Dep't of the Treasury, *The Financial Crisis Response in Charts* (April 2012), [https://www.treasury.gov/resource-center/data-chart-center/Documents/20120413\\_FinancialCrisisResponse.pdf](https://www.treasury.gov/resource-center/data-chart-center/Documents/20120413_FinancialCrisisResponse.pdf) (accessed Feb. 10, 2016).

5. *Id.*

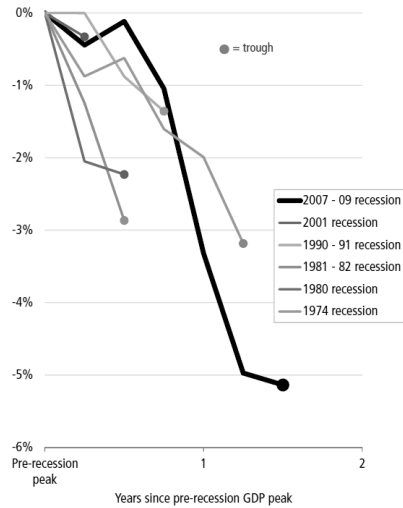
6. See Tyler Atkinson et al., *How Bad was It? The Costs and Consequences of the 2007-09 Financial Crisis*, FED. RES. BANK DALLAS, no. 20, July 2013.

7. In a September 19-20, 2015 WSJ article (p.A3) it was indicated that valuations of stocks and mutual funds have greatly surpassed pre-crisis levels, while non-financial assets (primarily real estate) have barely reached their pre-crisis level. Josh Zumbrun, *Household Wealth Climbs to Fresh High*, WALL ST. J., Sept. 10-20, 2015, at A3.

indicates, world output declined, and as of 2012 had not returned to its previous trend level.

Figure 1: This Recession Was the Worst since the Great Depression

Real GDP, percent fall from pre-recession peak



Metrics of the '07 - '09 financial crisis, peak-to-trough:

**8.8 million**  
jobs lost

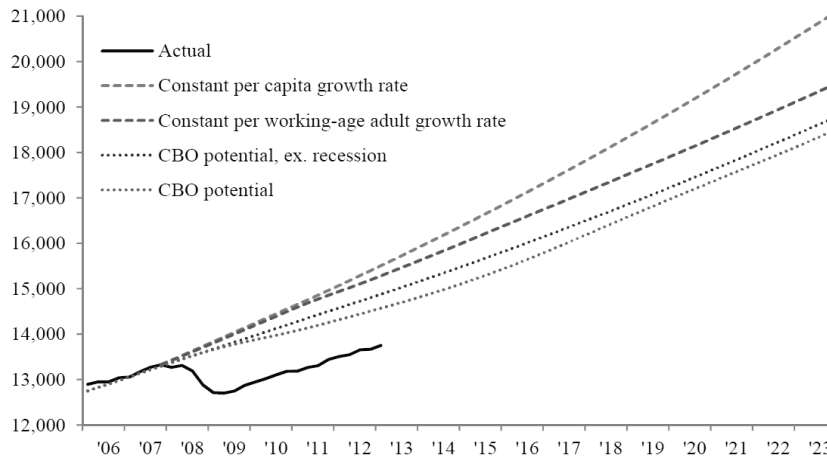
**\$19.2 trillion**  
lost household wealth  
(2011 dollars)

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Flow of Funds.

U.S. DEPARTMENT OF THE TREASURY

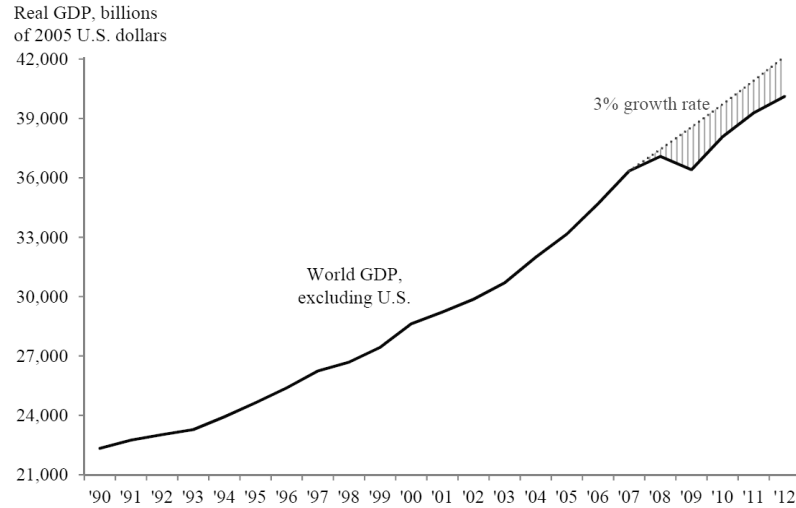
Figure 2: Output Loss Is Sensitive to Different Assumptions about Trend

Real GDP, billions of 2005 dollars



SOURCES: Bureau of Economic Analysis; Census Bureau; Congressional Budget Office; authors' calculations.

Figure 3: Financial Crisis Impact Not Limited to Domestic Output



SOURCES: World Bank; authors' calculations.

What were the causes of this calamitous event? It is generally agreed that overinvestment, especially in housing assets, was the principal initiating cause of the Great Crisis. Several factors came together to cause the overinvestment in housing. One was the government's social policy of encouraging home ownership. A second was the absence of regulation of banks and shadow banks, partly the result of the deregulation of the financial system completed in the Gramm-Leach-Bliley Act of November of 1999. With regard to social policy, Agarwal et al. offer evidence that the Community Reinvestment Act of 1977 pushed banks in the direction of providing riskier mortgage financing for low-income and minority groups, especially in and around regulatory conformance exam dates.<sup>8</sup> The Housing and Community Development Act of 1992 and subsequent political pressure from the Clinton Administration required the mortgage purchasers, Fannie Mae and Freddy Mac, to invest a substantial proportion of their portfolio in affordable housing mortgages. Both of these acts of Congress facilitated an expansion in housing demand (especially by those income groups least able to service their mortgage debt) and contributed to the increased but unsustainable price appreciation of real estate assets in the run-up to the crisis.

Innovations in financial contracting also contributed to the expansion in demand for housing assets. Securitization enabled banks to make loans to home buyers and then off-load them to a securitizing trust that in turn sold claims against the trust in the capital market. The individual mortgages became constituent parts of a portfolio within the trust whose tranches trade in the capital market. The advantage of securitization is reduced risk of the portfolio due to diversification. The disadvantage is the absence of

8. Sumit Agarwal et al., *Inconsistent Regulators: Evidence from Banking*, Q. J. ECON. 129, 889-938 (2014).

subsequent monitoring of each individual mortgage within the portfolio, and a moral hazard problem. The moral hazard problem is that banks have less incentive to evaluate the creditworthiness of their individual mortgage customers when they lend only to subsequently distribute. In addition, the investment quality of the various tranches proved difficult to evaluate by the credit rating agencies. Since credit ratings are paid by the issuer of the securities being rated, there was a natural bias for the rating agencies to overrate the various tranches. Other innovations include low down payments, various forms of back loading the mortgage contract, and adjustable rate mortgages, such as the 2/28 mortgage. The 2/28 mortgage offered the borrower a low fixed-rate for two years and then floated with some short-term rate, like the London Interbank Offer Rate (“LIBOR”), plus a risk premium. These somewhat exotic contract forms, along with the encouragement of government policy, enabled many individuals who were unable to obtain a standard qualified mortgage to obtain the financing necessary to buy a home. US social policy during this period seemed to tolerate wide dispersion in the distribution of after-tax income, but less dispersion in access to housing assets and other financial products.

Perhaps even more important than government policy towards housing was the erratic pattern of monetary policy from 2002 through 2007. The growth rate of M1 went from an annual average of 5.2 percent during the run-up of housing asset prices in 2002–2005, to a -.23 percent from 2005–2007 during which housing investments and valuations tapered off and began to fall.<sup>9</sup> In the run-up period, monetary policy increased bank reserves enabling banks to increase their investments in mortgages; while at the same time falling interest rates were inducing households to increase their demand for investments in housing assets. Another contributing factor increasing the supply of bank loans to the housing sector was the increase in bank share valuations reflecting a decline in the risk aversion of bank shareholders. Over the period 2002–2007 bank share valuations rose seven percent annually on average; thus reducing the equity cost of capital to banks. Finally, the global savings glut resulting from years of United States balance of payments deficits, first with Japan and then China, also supplied the finance for the strong demand for housing assets.

However, what goes up eventually comes down. The down period began with the tightening of monetary policy and its effects on interest rates. Housing demand began to fall in 2006/2007. With the fall in demand, the valuations of housing assets began to fall. The falling valuations of housing assets, along with the innovative contract forms that pushed payments into the future, resulted in negative equity for a growing number of home investors. Since most mortgages are non-recourse loans, many

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9. All data on the M1 measure of the money supply obtained from the Board of Governors of the Federal Reserve System in Money Stock Measures-H-6. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONEY STOCK MEASURES – H.6 (2002 – 2007).

households with negative equity were forced to default on their mortgages and surrendered their home to the bank.<sup>10</sup> Banks typically sold the home as fast as possible thereby exacerbating the decline in the valuations of housing assets and creating a downward valuation spiral in the housing market. The losses being realized in the banking system soon spread to the interconnected and highly levered shadow banks, who had difficulty funding the various tranches of securitized mortgage pools they held in their portfolio. Some (e.g., Lehman Bros.) went bankrupt, others (e.g., Bear Stearns and Merrill Lynch) were merged into stronger banks, and still others (e.g., Goldman Sachs and Morgan Stanley) became banks in order to access Federal Reserve funding. For all practical purposes, the large traditional investment banks disappeared. Money market mutual funds that provided commercial paper and repo financing to these large investment banks, stopped funding them when Reserve Primary Fund (the oldest money market mutual fund in the United States) “broke the buck” as a result of large investments in the short-term liabilities of Lehman and fled to safety by investing in short-term treasury securities. The integrated financial system was breaking down and unable to fulfill its financial intermediation function. In response to this breakdown, the US Treasury Department guaranteed the shares of money market mutual funds from September 2008 to September 2009; much like the Federal Deposit Insurance Corporation’s (“FDIC”) guarantee of bank deposits.<sup>11</sup> Furthermore, the Federal Reserve temporarily provided commercial paper funding to American and foreign firms October 2008 to February 2009.<sup>12</sup>

The decline in the valuation of housing assets spread to the stock market and other sectors of the economy. The stock market rose sharply from August 2002 to October 2007 (as investor risk aversion fell), and then fell precipitously (as risk aversion rose) possibly as a result of the housing crisis reaching a low in February 2009. Declining valuations in housing and stock market assets had real effects on consumption and real-investment spending. When housing and stock market valuations increase, households

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10. Much has been made of optimal strategic default decision in the literature. However, Gerardi et al., using new data from the Panel Study of Income Dynamics, find that the vast majority of defaults were not the result of a calculated strategic default decision but of the simple fact that the defaulter (and/or spouse) lost a job, got divorced, experience unexpected medical expenses, and other unexpected negative shocks to income and wealth. For the most part, defaulters didn’t have the resources to service the mortgage. Moreover, even for those households who are unable to pay, many find a way to continue to pay. People will do everything possible to stay in their own home. Gerardi, Kyle F. Herkenhoff, Lee E. Ohanian & Paul Willen, *Can’t Pay or Won’t Pay? Unemployment, Negative Equity, and Strategic Default* (NBER, Working Paper No. w21630, 2015), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2672744](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2672744).

11. The Dep’t of the Treasury, Treasury Announces Temporary Guarantee Program for Money Market Funds, Press Center (Sept. 29, 2008), <https://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx>.

12. Federal Reserve History, The Federal Reserve, Federal Reserve Credit Programs During the Meltdown (Oct. 2008), <http://www.federalreservehistory.org/Events/DetailView/70>.



consider those increases as a form of savings. When these valuations decrease, households respond by decreasing consumption to build up savings and to reduce their debt outstanding. In this connection, Angrisani et al. found that for every dollar decline in the valuations of housing assets, consumption fell by seven cents.<sup>13</sup> They also found that a dollar decline in stock market wealth was associated with a four-cent decline in consumption. With consumption falling, firms cut back on investment, production, and employment; thereby producing the most severe recession the country experienced since the Great Depression.

## II. THE REGULATORY RESPONSE TO THE GREAT CRISIS

Whenever an economy experiences a finance initiated recession of the magnitude experienced by the United States and the developed economies of the world, a regulatory response is not far behind. This is especially true when those in the financial sector, who many blamed for the crisis, received and continued to receive high and well-publicized executive pay packages. One regulatory response for the developed countries of the world took the form of the Third Basel Accord (“Basel III”). Basel III raised the minimum capital and liquidity requirements for internationally active banks.<sup>14</sup> The idea was that if banks and so-called shadow banks had more equity capital to absorb losses stemming from the real estate sector and more liquidity to ward off runs on deposits and repurchase agreements, the financial and economic crisis of 2007–2009 might have been avoided or at least blunted to a considerable extent.

Basel III was an international regulatory response to the crisis. The regulatory response in the United States took the form of Dodd-Frank passed by Congress and signed into law on July 21, 2010. Dodd-Frank represented a comprehensive re-regulation of the U.S. financial system<sup>15</sup> In this paper, we will focus on Title X or the consumer protection part of the Act.

Typically, financial induced economic crises reveal a number of sharp, if not outright, fraudulent practices. The recession of 2008-2009 was no exception. Many of the sharp, if not fraudulent, practices during this period centered on the complex contract forms of home mortgages, credit card borrowing, and payday loans. While the questionable practices in contract form were not a major cause of the recession, they served as a flashpoint for the human suffering that accompanied the recession. Therefore, a regulatory response was inevitable.

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13. Marco Angrisani et al., *The Effect of Housing and Stock Wealth Losses on Spending in the Great Recession* (Rand Labor & Population, Working Paper No. 1101, 2015).

14. Basel Committee on Banking Supervision, Bank for International Settlements (Mar. 2015), <http://www.bis.org/bcbs/publ/d312.pdf>.

15. For a description of the Dodd-Frank Act see Krainer, R. 2012. *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance, a Review*, J. FIN. STABILITY 121-133 (2012) (discussing the Dodd-Frank Act).

Dodd-Frank created the CFPB. The Bureau took over many (but not all) of the regulatory duties that previously were carried out by other government agencies in the area of financial regulation.<sup>16</sup> The CFPB is set up and financed within (but completely independent of) the Federal Reserve. The Director of the Bureau is appointed by the President subject to the confirmation of the Senate; although, the first Director was appointed during a congressional recess and was not confirmed by the Senate until two years after his appointment.<sup>17</sup> The CFPB enjoys a level of financial independence from Congress that is rare for a government agency. Its annual budget is paid by the Federal Reserve and is very generous. Its budget cannot exceed an amount greater than 12 percent of the budget of the Board of Governors of the Federal Reserve System.<sup>18</sup>

The main purpose of the CFPB is to administer, implement, and enforce consumer protection laws. It does this by conducting educational programs, responding to consumer complaints, and conducting research so as to identify risks to a consumer from financial products.<sup>19</sup> The general idea is to prohibit unfair, deceptive, and abusive practices in the sale of financial products. The CFPB was purposely given a broad mandate by Congress that is somewhat vague, in order that, with time, it could identify unfair, deceptive, and abusive practices and formulate specific rules against these practices. Some of these rules include:

- i. Regulate private student loans and the servicing of loans.
- ii. Regulate certain fees in connection with credit card and debit card transactions.
- iii. Set standards for Qualified Mortgages.
- iv. Regulate certain aspects of payday loans.
- v. Regulate electronic fund transfers.
- vi. Regulate prepaid cards.<sup>20</sup>

In regulating these various types of consumer financial products the Bureau has accumulated a wide range of regulatory authority over financial institutions. For example, they have the power to issue subpoenas, conduct

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16. Legal Information Institute, *supra* note 3.

17. Robert E. Krainer, *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance, a Review*, 8 J. OF FIN. STABILITY 121, 121-133 (2012)

18. Consumer Fin. Prot. Bureau ("CFPB"), *The CFPB Strategic Plan, Budget, and Performance Plan and Report* (Feb. 2016), [http://files.consumerfinance.gov/f/201602\\_cfpb\\_report\\_strategic-plan-budget-and-performance-plan\\_FY2016.pdf](http://files.consumerfinance.gov/f/201602_cfpb_report_strategic-plan-budget-and-performance-plan_FY2016.pdf).

19. CFPB, *About Us*, <http://www.consumerfinance.gov/the-bureau/>.

20. CFPB, *Overview of the CFPB*, <http://www.consumerfinance.gov/strategic-plan/>.

hearings, issue cease-and-desist orders, request data, and levy fines on financial institutions selling financial products to households. Their mandate from Congress seems more open-ended than the mandates for other regulatory authorities.

### III. AN EVALUATION OF CONSUMER PROTECTION

#### *A. A New Philosophy of Regulation*

The Great Crisis has given rise to a new economic philosophy towards consumer protection and regulation. Previously the underlying philosophy was based on Neo-Classical economic theory. According to this theory the job of the regulatory authority was to eliminate fraud and to make sure that consumers had full information on products available for sale in the market place including financial products. Households were assumed to be rational decision-makers, but needed help in overcoming the problem of asymmetric information between the seller and buyer of a financial product. Regulation provided that help. The philosophy of regulation in the post Great Crisis took the form of the CFPB, and is partly based on what has come to be called Behavioral Economics.<sup>21</sup> Behavioral economics and finance have uncovered a number of empirical anomalies in the behavior of investors and managers of firms that have been interpreted by some economists and legal scholars as a rejection of the full informational efficiency of financial markets. In addition to requiring vendors to provide full information about a product, behavioral economics and law takes the view that some consumers have to be protected from their inability to make rational decisions even when they have easy access to full information.

Nowhere is this more evident than in the area of contract form in the housing market and various markets for consumer credit. These contracts are often quite lengthy, complex, and written at a level of English that exceeds the level for the average person. It has been argued that these complex contract forms contributed to the large number of mortgage defaults and forfeiture of homes during the Great Crisis.<sup>22</sup> Perhaps the most noteworthy features in these non-traditional home mortgage contracts were adjustable rate mortgages and the so-called “back loading” of mortgages. Adjustable rate mortgages start off with low interest rates, and with time the interest rate would adjust upward. Back loading, or negative amortization, mortgages occur when interest and principal payments get pushed from the present into the future. Both adjustable rates and the back-loading of mortgages made future interest payments much higher, and the pay down of

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21. For a more detailed account of the role of Behavioral economics and law in the Dodd-Frank Act see: Jason Scott Jonson, *Do Product Bans Help Consumers? Questioning the Economic Foundations of Dodd-Frank Mortgage Regulation* (U. of Virginia Sch. of Law, Pub. Law and Legal Theory Research Paper Series 2015-22)

22. Robert E. Krainer, *Economic Stability Under Alternative Banking Systems* (Sept. 14, 2012), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2147888](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2147888).

principal much lower which, when combined with falling house prices, contributed to the large number of defaults that occurred during the crisis. Since some home buyers were surprised by the payment pattern of these non-standard mortgages, one policy suggestion would be to require mortgage issuers to provide printouts of future payments schedules for the life of the mortgage contract under several assumptions regarding movements in future interest rates. This would enable households to observe the future pattern of mortgage payments upfront, thereby, shifting the surprise from the future to the present when a decision is in the process of being made.

How did the CFPB react to this problem? The CFPB has chosen not to ban these complicated mortgage contract forms. What they have done is to define what constitutes a qualified mortgage. These standards include the following:

- i. Points and fees cannot exceed three percent of the amount borrowed.
- ii. No interest only or negative amortization loans. Similarly, no balloon loans with certain exceptions for rural and farming areas.
- iii. Debt to income ratio cannot exceed 45 percent.
- iv. Lender must make a good faith determination of the borrower's ability to repay the loan. This standard also applies to payday loans and credit card debt.
- v. Restrictions on pre-payment fees which can only be used on 30 year fixed rate mortgages.
- vi. Prohibition on steering fees to brokers for the sale of certain high-priced and complicated contract forms.
- vii. Prohibits predatory debt collection and debt servicing.

All mortgages not meeting the standard of a qualified mortgage are then classified as a non-qualified mortgage. The distinction between a qualified versus a non-qualified mortgage is potentially important. A qualified mortgage is granted a "safe harbor" for the issuing bank protecting them from future liability under the "truth-in-lending" laws. Such protection would not necessarily be accorded to issuers of non-qualified mortgages. In this way the CFPB "nudges" mortgage underwriters to supply more qualified mortgages and fewer non-qualified mortgages.

The regulatory reach of the CFPB goes beyond mortgage contracts. For example, credit card companies are now required to assess the ability of borrowers to repay credit card debt incurred. The CFPB also regulates certain fees, although, the Federal Reserve still retains the regulation of interchange fees of credit card companies. Credit card companies cannot

retroactively increase interest rate except when the cardholder is delinquent on payments for more than 60 days. For cardholders in general, the card company cannot raise rates on borrowing or implement new fees (e.g., foreign exchange fees) without first informing the cardholders. Finally, credit card companies cannot restrict retailer discounts to customers for cash payments.

Another financial institution that came under heavy criticism after the Crisis were payday lenders. Alarming stories of individuals paying up to 400% interest in a debt spiral of re-borrowing just to pay interest, although probably rare, were enough to spur a regulatory response.<sup>23</sup> Some called for a complete ban on payday lending. Advocates for the industry claim that payday lending fills a gap in the financial system that enables low income groups access to credit to meet unexpected emergencies. On the other hand, Cuffe and Gibbs find that the State of Washington's restrictions on payday lending were associated with a reduction in the sales of liquor at state liquor outlets.<sup>24</sup> Moreover, the reduction in sales of liquor were greatest the closer the payday lender was to the liquor store.

What restrictions on payday lending are in place? Payday loans in the amount of \$2000 or less, with a maturity of 91 days or less, with interest rates in excess of 36 percent, are banned by the military under the 2007 Military Authorization Act.<sup>25</sup> Previous to this Act, military personnel were relatively heavy users of payday loans. Payday loans are also subject to CFPB regulations. On March 26, 2015 the CFPB proposed that payday lenders must do an analysis on whether the borrower can pay back the loan. They also imposed limitations on collection practices, loan rollovers, allow no mandatory waiver of consumer protection laws, allow no prepayment fees, and other regulations.

### *B. Some Costs of Regulation*

The above described regulations are designed to have an effect. The designed effect is to dampen the supply of financial products that will potentially jeopardize the financial health of individuals and the health of the entire financial system, through the inter-connectedness of financial institutions. This is the behavioral aspect of the new regulation. However, many economists and legal scholars remind us that financial regulations that ban or raise the price of some financial products will necessarily preclude some individuals from obtaining the financial products that *ex-post* would maximize their utility. The problem is that it is impossible to know

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23. CFPB, What is a Payday Loan?, <http://www.consumerfinance.gov/askcfpb/1567/what-payday-loan.html>.

24. Harold E. Cuffe & Christopher G. Gibbs, *The Effect of Payday Lending Restrictions on Liquor Sales* (Victoria Univ. of Wellington Sch. of Econ. and Fin., Working Paper No. 11/2015) <http://ssrn.com/abstract=2652018>.

25. Scott Carrell & Jonathon Zinman, *In Harm's Way? Payday Loan Access and Military Personnel Performance*, *Review of Financial Studies* 27, 2805-2840 (2014).

*ex-ante* which individuals (and at what time in the financial and economic cycle) will (or will not) jeopardize their own financial health and the health of the financial system. Complicated contract forms were helpful to some households in certain time periods and under certain circumstances. In this connection, back-loaded mortgages can make a great deal of economic sense for some individuals when certain conditions hold. For example, some households may experience income growth (or a bequest) in the future enabling them to afford high debt service charges in the future compared to the present. Other households might be able to service present mortgage payments, but a short-term emergency (e.g., medical expense or college expenses) might arise making it convenient to push debt service into the future. Critics of the CFPB point to other costs of the regulatory response to the Great Crisis. According to Zywicki the number of unbanked households increased after the passage of Dodd-Frank.<sup>26</sup> In a 2013 FDIC survey, 9.6 million US households (7.7 percent of all households) did not have a bank account.<sup>27</sup> In the same survey, the FDIC found that 20 percent of all US households were underbanked, in that they did not have access to certain financial products offered by banks. Free checking has disappeared for a number of individuals and monthly maintenance fees have doubled. One reason was that banks were forced by Dodd-Frank to get out of certain lucrative, but risky, lines of business. To recapture the lost revenues, banks raised the fees (when they could) on a number of financial products they sold to households. Finally, CFPB data for the end of 2012 indicate credit card use and lines have declined by \$200 billion since February 2010 when the Credit Card Accountability and Disclosure Act took effect. The higher price of financial services have had a disproportionate effect on low income households. Finally, the record keeping necessary to comply with CFPB regulations has been burdensome to banks in general, and small banks in particular. And yet, Mian and Sufi provide strong empirical evidence that households with Vantage Score scores below 700 had the largest growth in debt in the run-up period between 2000–2007 and the largest default rate in 2007–2008.<sup>28</sup> That triggered the Crisis that, so far, has resulted in lost GDP somewhere between \$6 trillion and \$14 trillion, not to mention the ill-health side-effects and criminal activity that accompanies recessions of this magnitude.<sup>29</sup> The question is whether the costs (which fall on the rich and

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26. Todd Zywicki, *The Dodd-Frank Act Five Years Later: Are We More Stable?*, GEO. MASON UNIV. LAW & ECON. RES. PAPER SERIES, 15–28 (2015).

27. See *2013 FDIC Survey of Unbanked and Underbanked Households*, Federal Deposit Insurance Corporation (last updated Oct. 28, 2014), <https://fdic.gov/householdsurvey/2013report.pdf>.

28. Mian, A and Sufi. *Household Debt and Defaults from 2000-2010: Facts from Credit Bureau Data*. (Chicago Booth, Working Paper No. 129, 2015).

29. Vantage scores vary between 550 and 990 whereas FICO scores vary between 300 and 850. According to Mian and Sufi Vantage scores below 700 indicate a low credit score. Atif Mian & Amir Sufi, *House Price Gains and U.S. Household Spending From 2002 to 2006* 19 – 20 (National Bureau of Economic Research, Working Paper 20152, 2014).

poor) resulting from added financial regulation will materially reduce the likelihood of future crises.

*C. Conflicting Goals in U.S. Government Policy: Financial Stability vs Accessible Credit for All*

Is it possible for the CFPB to achieve the goals of government policy towards consumers in the mortgage and other financial product markets? If the only goal of government policy is to protect consumers, the answer is probably yes. In a broader sense, the answer is decidedly no. The answer is no because government is simultaneously pursuing three policies that at times are working at cross purposes to each other. One policy beginning in the early 1980s had the effect of changing the distribution of income to become more skewed towards the rich.<sup>30</sup> This policy was primarily implemented by reducing the progressivity of the US personal income tax. Since the rich have a high propensity to save (an MPS=.5 according to Dynan et al., it is necessary that medium and low income groups have access to credit in order to spend for goods and services in order to maintain aggregate demand and relatively full employment.<sup>31</sup> Evidence that the consumption share of the bottom 95 percent did not fall as much as their share in income is provided by Krueger and Perri.<sup>32</sup> The social policy was designed to encourage home ownership for all income classes in order to foster domestic tranquility. This policy takes a number of different forms. One form is the tax deductibility of interest on borrowings to finance home ownership. This form benefits all income classes. A second form is implemented by the Federal Home Loan Banks originally created by Congress in 1932. The Federal Home Loan Banks lend to local financial institutions that, in turn, finance local home ownership and local economic development projects. This policy has mainly benefited medium and low income families. A third form, since 1934, is the subsidized government insurance of mortgages provided by the Federal Housing Administration (FHA) which enables lenders to offer low down payments and closing costs making it easier for borrowers to qualify for mortgage credit. This policy has also mainly benefited medium and low income groups. A fourth form this housing policy takes is designed to provide liquidity to the secondary mortgage market. This policy benefits all income classes. To achieve this goal Congress set up two government sponsored agencies (GSE's); Fannie Mae ("Fannie") in 1938 and Freddy Mac ("Freddy") in 1970. Fannie and Freddy provide liquidity to the secondary mortgage market in that they

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30. Piketty, T and Saez E., *Income Inequality in the United States, 1913-1998*, Q. J. OF ECON., Feb. 2003 at 1-39. U.S. DEP'T OF TREASURY, THE FINANCIAL CRISIS RESPONSE IN CHARTS. (Apr. 2012).

31. Karen E. Dynan, Jonathan Skinner & Stephen P. Zeldes, *Do the Rich Save More?*, J. OF POL. ECON. 397, 429-44 (2004)

32. Dirk Krueger & Fabrizio Perri, *Does Income Inequality Lead to Consumption Inequality? Evidence and Theory*, 73 Rev. of Econ. Stud. 163, 163-193 (2006).

purchase home mortgages from private financial institutions. The fifth policy was the enactment of the Community Reinvestment Act of 1977.<sup>33</sup> To help low and middle income groups, the Act requires supervisory agencies such as the Federal Reserve, the Comptroller of the Currency, and the Office of Thrift Supervision to encourage the financial institutions they regulate to reinvest in the communities in which they are located. The primary goal of Congress in establishing these government-sponsored enterprises is to provide low cost subsidized financing for home purchases made by medium and low income groups.

In juxtaposition to these two policies of allowing a more skewed distribution of income favoring the rich and at the same time facilitating access to credit by medium and low income groups to maintain aggregate demand and employment, Congress has pursued policies designed to provide stability to the private financial system. This started with the Glass Steagall Act of 1933 in response to the Great Depression, and ended with Dodd-Frank in response to the Great Recession.<sup>34</sup> The vigorous pursuit of the policies that promote access to credit and home ownership for all will eventually compromise the policies directed towards attaining financial and economic stability which then will eventually result in a financial and economic crisis which then will result in government pursuing policies designed to achieve financial and economic stability which then compromises the policies designed to promote home ownership and access to credit for all. This back and forth on the pursuits of these two incompatible policies serves no useful purpose for society and contributes to the volatility of economic activity.

Can the goals of these policies be made compatible? Probably not.<sup>35</sup> Kumhof et al. — in the context of a Dynamic Stochastic General Equilibrium (“DSGE”) model where income inequality and personal leverage are explicitly modeled—suggests that a reversal of the growing inequality of income would reduce the financial leverage of medium and low income families and reduce the probability of a future financial and economic crisis.<sup>36</sup> Barring a reversal of the growing inequality of income, we suggest a way to, perhaps, side-step this incompatibility across different government policies. That suggestion would take the financing of the policy

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33. Board of Governors of the Federal Reserve System, Community Reinvestment Act (CRA), [https://www.federalreserve.gov/communitydev/cra\\_about.htm](https://www.federalreserve.gov/communitydev/cra_about.htm).

34. Fed. Reserve History, Banking Act of 1933, Commonly Call Glass-Steagall, <http://www.federalreservehistory.org/Events/DetailView/25>.

35. What about financial education? Providing financial literacy to consumers is one of the stated goals of the CFPB. But will financial education help turn irrational consumers into rational consumers? Perhaps. But according to, financial education programs have not been too successful to date. One reason for this is that the financial products industry is very dynamic and continually changing partly in response to changing regulation. Lauren E. Willis, *The Financial Education Fallacy*, 101 AM. ECON. REV. 429, 429-434 (2011).

36. Michael Kumhof, Romain Ranciere & Pablo Winant, *Inequality, Leverage, and Crises*, 105 AM. ECON. REV. 1217-1245 (2015).



of credit access and housing for medium and low income families out of the private banking and shadow banking sectors and put it into a newly created government sponsored enterprise (“GSE”). Access to this GSE would only be available to individuals below some predetermined income level. Low income households would apply directly to this government financial institution for a home loan, and if made, the loan would remain on the books of this government institution. This would make it different than the FHA, Fannie Mae, and Freddy Mac in that the GSE would directly lend to low income households and hold the loan to maturity or default. Consequently, the risky subprime mortgage loans of low income families would not be on the balance sheet of a private financial intermediary and potentially weaken the private financial system.<sup>37</sup> An example of this type of financial institution is the Federal Farm Credit System that provides subsidized financing for farms and other agricultural enterprises. We further recommend that the financing of this government enterprise be a line item in the government budget so that the executive and legislative branches would be required to prioritize it relative to competing uses of government funding. In this way, the social goal of subsidizing home ownership for all would become a part of fiscal policy, just like other welfare programs of the government. Running the social program of credit access and housing for low income groups through the private financial sector risks bankrupting the banking and financial system when the housing market collapses, as emphasized by Mian and Sufi.<sup>38</sup> A bankrupt banking system is not able to perform its financial intermediation function. The end result is that the crisis in banking spreads to the real economy causing a recession. Then the government has to bail out the banking system and the real economy through fiscal and monetary policy. Putting the financing of low income housing into a GSE would further insulate the private financial system and the real economy from the mortgage defaults occurring in low income groups. Of course, in practice there would be challenges to implementing this scheme. What should be the income requirement for access to this form of mortgage finance? Would this represent unfair competition for private financial institutions making mortgage loans? Nevertheless, \$6–14 trillion of lost output triggered by the creation and bursting of the real estate bubble is a heavy price to pay for implementing welfare programs through the private banking system.

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37. In a way, this may seem similar to the “good” bank, “bad” bank of the original version of the Troubled Asset Relief Program signed into US law in October 2008. However, there are important differences. Under our plan the government sponsored enterprise (GSE) would initiate the loans, and the volume of loans would be limited to the amount budgeted by Congress. Within this GSE there would be no, so-called, “Hustle” program like there was at Countrywide bank, where mortgage salespersons were compensated solely on the basis of the volume of mortgages written with no regard for the quality of the loans made.

38. Mian, A and Sufi. *Household Debt and Defaults from 2000-2010: Facts from Credit Bureau Data*. (Chicago Booth, Working Paper No. 129, 2015).

## IV. SUMMARY AND CONCLUSIONS

Dodd-Frank that gave birth to the CFPB was the regulatory response to the severest financial and economic crisis the country has experienced since the Great Depression of the 1930's. The Dodd-Frank Wall Street Reform part of the Act was intended to prevent the banking system and the shadow banking system from implementing a business plan that would compromise the financial intermediation function of financial institutions that is so necessary for the efficient functioning of the real economy. It was also designed to prevent public bailouts of private firms. The CFPB part of the Act was designed in part to provide more information to consumers of financial products, and in part to make it more difficult for financial institutions to supply financial products that turned out—in retrospect—to be toxic to some consumers and the financial system. The foundation for both policy initiatives was based on an assessment of what it would have taken to prevent the Great Crisis from beginning in 2007. Many economists and legal scholars think this is like preparing for the next war as if it will be the same as the last war. The next financial/economic crisis will probably be different. The important question is whether the policy changes implemented under Dodd-Frank will be flexible enough to deal with any, and all future economic crises emanating from the financial side of the economy.<sup>39</sup>

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39. My thanks to Werner DeBondt, James Johannes, and Elizabeth Odders-White for comments on earlier versions of this paper. They, of course, bear no responsibility for any remaining errors.