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TESTIMONY

INCREASING THE EFFECTIVENESS OF THE BUREAU OF CONSUMER FINANCIAL PROTECTION IN PROTECTING CONSUMERS

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Testimony Before the Financial Institutions and Consumer Credit Subcommittee
of the House Committee on Financial Services

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Chairman Capito, Ranking Member Meeks, and members of the committee, thank you for the opportunity to testify today about needed reforms of the Bureau of Consumer Financial Protection. The Bureau's self-described mission is "to make markets for consumer financial products and services work for Americans—whether they are applying for a mortgage, choosing among credit cards, or using any number of other consumer financial products."[1] The Bureau's structural flaws threaten to undermine that mission. Today, I will discuss three of those flaws—the lack of accountability, the opacity of the Bureau's decision-making processes, and the flaws in the Bureau's organic statute—and potential avenues for addressing them in a manner that makes the Bureau more effective at protecting consumers. These incremental reforms are not a substitute for more fundamental reforms, such as placing the Bureau in the congressional appropriations process and replacing the director with a bipartisan commission.

The Bureau is rooted in a commendable desire to ensure that the financial system is meeting the needs of consumers. In a recent speech, Director Richard Cordray explained that the Bureau "seek[s] some fairly basic things," including "to hold financial companies accountable for being up front about the costs and risks of their products" and "to see that throughout the financial marketplace consumers are treated fairly and with the dignity and respect they deserve."[2] An agency that is not accountable and "up front" about the costs and risks of its regulatory actions and one that does not treat the entities it regulates fairly is not well positioned to achieve these objectives. Dodd-Frank created the Bureau without the structural features that are typically in place to help agencies function effectively.[3] While I cannot comment on the specific legislative text of the proposals before the Subcommittee today, the incremental reforms that I

1. Bureau of Consumer Financial Protection, "About Us," http://www.consumerfinance.gov/the-bureau/, accessed May 14, 2014..
2. "Prepared Remarks of CFPB Director Richard Cordray at the Federal Reserve Bank of Chicago," May 9, 2014, http://www.consumerfinance.gov/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-federal-reserve-bank-of-chicago-2/.
3. For an analysis of the Bureau's structural flaws, see Todd Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?" *George Washington Law Review*, Vol. 81 (2013): 856-928.

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discuss below, by addressing these structural weaknesses, should serve to improve the Bureau's ability to serve consumers.

LACK OF ACCOUNTABILITY

The Bureau's creators designed it to be independent of the President and Congress. Rather than being under the guidance of a politically balanced commission, the Bureau is run by a single director with a five-year term who may only be removed for cause—not for policy reasons. The President's authority over the Bureau's director is, therefore, quite limited, as is Congress's. The Bureau's budget comes not from Congress but from the Federal Reserve System's earnings in an amount—subject to a cap—determined by the Bureau's director. The Bureau also operates independently from the Federal Reserve, within which it is housed, and from the other regulators charged with overseeing banks' safety and soundness.[4] As a consequence, the Bureau's ability to fulfill its mission is inextricably tied to the whims, will, and weaknesses of the director who heads it.

Requiring the Bureau to have a dedicated inspector general would enhance the agency's limited accountability. An inspector general can play an important role in overseeing the operations of an agency and investigating potential misconduct by agency officials. The Bipartisan Policy Center recently recommended that "[a]n independent Bureau should have a correspondingly independent inspector general with full investigative and reporting powers."[5] Currently, the inspector general for the Board of Governors of the Federal Reserve System, who is appointed by the Federal Reserve Board chairman, is also responsible for overseeing the Bureau.[6] This sharing arrangement means that neither the Federal Reserve Board nor the Bureau is properly overseen. The inspector general's dual mission is particularly unworkable because Dodd-Frank substantially broadened the Board's regulatory authority.[7] The shared inspector general has produced valuable reports regarding the Bureau.[8] A presidentially appointed, Senate confirmed, dedicated inspector general would be able to provide more rigorous oversight.

The Bureau's examination function is another area in which additional accountability is needed. Through the examination process, agencies work with regulated entities to improve their compliance functions. Examinations afford an opportunity for educational interaction between a regulated entity and agency staff, and the end result may be a list of items for the regulated entity to address. Regulators, for their part, should strive to obtain the information they need without imposing undue burdens on the examined entity. This is particularly important for the Bureau, which regulates banks that are also being examined by one or more other regulators. The Bureau's decision to stop including enforcement attorneys on examination teams was wise.[9] Nevertheless, the Bureau continues to tout the usefulness of examinations as a source of enforcement actions.[10] While it is natural that some enforcement actions will arise from examinations, statutory limits on the way the Bureau plans, conducts, and

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4. The Financial Stability Oversight Council has limited ability to review Bureau regulations. 12 U.S.C. § 5513.
5. Bipartisan Policy Center, "The Consumer Financial Protection Bureau: Measuring the Progress of a New Agency," September 2013, p. 43.
6. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1081, 124 Stat. 1376, 2080 (2010) (codified at 5 U.S.C. app. § 8G(c)).
7. See, for example, Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank," infographic, Mercatus Center at George Mason University, November 13, 2013, http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank.
8. See, for example, Office of Inspector General, "The CFPB Can Improve the Efficiency and Effectiveness of Its Supervisory Activities," March 27, 2014, http://www.federalreserve.gov/oig/files/CFPB-Supervisory-Activities-Mar2014.pdf; Office of Inspector General, "The CFPB Should Reassess Its Approach to Integrating Enforcement Attorneys into Examinations and Enhance Associated Safeguards," December 16, 2013, http://www.federalreserve.gov/oig/files/CFPB_Enforcement_Attorneys_Examinations_full_Dec2013.pdf.
9. The Bureau explained to the inspector general that "we determined that by discontinuing CFPB enforcement attorneys' involvement in on-site examinations generally, and by clarifying enforcement attorneys' role in examination support, we would achieve greater capacity and more efficiency in all offices." Office of Inspector General, "The CFPB Should Reassess Its Approach to Integrating Enforcement Attorneys into Examinations and Enhance Associated Safeguards," December 16, 2013, p. 25.
10. Director Cordray recently explained that "[m]any of our most significant enforcement actions have occurred after the initial work was done by examination teams that identified violations and laid groundwork that was later taken up, developed, and completed by enforcement teams." "Prepared Remarks of CFPB Director Richard Cordray at the Federal Reserve Bank of Chicago," May 9, 2014.

closes examinations will serve to remind the Bureau that the core purpose of examinations is to foster voluntary compliance efforts—not to impose unnecessary costs and anxiety on entities trying to do the right thing.

OPACITY

In addition to its lack of accountability to the President and Congress, the Bureau operates without adequate transparency to the public. There are a number of areas in which transparency could be improved so that people affected by the Bureau's actions would have more notice and greater ability to offer input. It is critically important that the Bureau fully open its advisory committee meetings to the public, improve its communication with small banks and other small entities, and increase the transparency of the data and assumptions that underlie its decisions.

The Bureau draws on outside expertise through its Consumer Advisory Board and Community Bank Advisory Council, Academic Research Council, and Credit Union Advisory Council, but these groups' meetings are not, as a matter of course, open to the public.[11] The Federal Advisory Committee Act (FACA) requires that advisory committee meetings "be open to the public,"[12] but FACA does not apply to the Federal Reserve System, of which the Bureau is technically part.[13] The Bureau explains that, "[a]lthough not required to comply with FACA, the Bureau complies with the spirit of FACA by providing transparency into the discussions of each advisory group."[14]

Compliance in spirit is, in practical terms, selective compliance.[15] Full transparency is particularly important because the Bureau's director unilaterally selects the members of these committees.[16] In addition, with the exception of the Consumer Advisory Board, which was created by Dodd-Frank, the director also establishes these committees.[17] To the extent the Bureau holds public meetings, it should publicly identify the audience members whose expenses it covered.[18] There is nothing about the Bureau that would justify a departure from FACA, other than the agency's serendipitous, nominal placement within the Federal Reserve System.

The Bureau should be more open and communicative with small banks and other small businesses than it has been to date. In a recent survey that the Mercatus Center conducted, small banks told us that one of the biggest concerns they had was the Bureau.[19] Numerous banks cited uncertainty about the Bureau's actions as a cause of concern, even though the Bureau is not their direct regulator. More than half of respondents cited the Bureau as having a "significant negative impact" on their earnings.[20] The inspector general is working on a report on the Bureau's compliance with its obligations under section 1100G of Dodd-Frank to assess the effects of its regulations

11. Bureau of Consumer Financial Protection, "Advisory Groups Meeting Details," http://www.consumerfinance.gov/advisory-groups/advisory-groups-meeting-details/, accessed May 15, 2014.
12. 5 U.SC. App. § 10(a)(1).
13. 5 U.S.C. App. § 4(b)(2).
14. Bureau of Consumer Financial Protection, "Advisory Boards and Councils: Frequently Asked Questions," p. 8, http://www.consumerfinance.gov/f/201401_cfpb_advisory-board-councils-faqs.pdf.
15. As a puzzling example of how the Bureau complies with the spirit of FACA, the Bureau explains that "CBAC, CUAC, and ARC will not hold meetings at which the public will be present." Ibid., p. 11. This statement appears to contradict the immediately preceding statement that "the CFPB board and council charters contemplate public access to meetings, which will be noticed in the Federal Register, recorded and archived." Ibid. In practice, public access does not appear to be the norm.
16. Ibid., p. 2 ("Except as provided by statute, regulation, or other Bureau directive, the authority to establish, utilize, renew, abolish, or appoint members to advisory boards or Board or Councils is reserved to the Director of the Bureau ("Director") and may be exercised only by him.")
17. The Bureau explains that the director's authority to establish these committees comes from "the inherent Dodd-Frank Act" and 41 C.F.R. 102-3.50(d). Bureau FAQs, p. 2.
18. For an example of when the Bureau did not disclose its agreement to reimburse an audience member's travel expenses, see Rachel Witkowski, "How the CFPB Seeks to Shape the Message," *American Banker*, April 1, 2014, http://www.americanbanker.com/issues/179_62/how-the-cfpb-seeks-to-shape-the-message-1066604-1.html?zkPrintable=1&nopagination=1.
19. Hester Peirce, Ian Robinson, and Thomas Stratmann, "How Are Small Banks Faring Under Dodd-Frank?," Mercatus Working Paper, Mercatus Center at George Mason University, February 27, 2014, http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank.
20. Ibid., figure 41.

on small businesses, but the Bureau should not wait for the completion of this report to improve its outreach to small businesses.[21]

Transparency is also lacking with respect to the data, assumptions, and methodologies that underlie the Bureau's decisions. Such disclosures are commonplace for executive agencies as part of the regulatory impact analyses they are required to prepare. Circular A-4, which spells out how these analyses should be done, explains:

> A good analysis should be transparent and your results must be reproducible. You should clearly set out the basic assumptions, methods, and data underlying the analysis and discuss the uncertainties associated with the estimates. A qualified third party reading the analysis should be able to understand the basic elements of your analysis and the way in which you developed your estimates.[22]

The Bureau should be held to these same standards when it conducts analysis in connection with its rules and produces reports that may form the basis for subsequent rulemaking. Additional transparency would make it easier for outside experts to identify flaws or gaps in the Bureau's data, assumptions, or analysis.[23] The Bureau should welcome such input to ensure that its rules benefit consumers.[24]

Rulemaking conducted pursuant to the Administrative Procedure Act's (APA) notice-and-comment process affords interested parties an opportunity to comment and advance notice of a coming regulatory change. Regulatory agencies sometimes try to skirt these requirements by engaging in less transparent backdoor rulemaking.[25] The Bureau's avoidance methods include issuing guidance and using enforcement actions. For example, the Bureau issued guidance ostensibly directed toward indirect auto lenders that specified steps for compliance with existing law.[26]

An even more troubling practice is the Bureau's intentional perpetuation of statutory ambiguities in order to allow further clarification through enforcement actions. The most notorious example of this is the Bureau's decision not to define the unclear jurisdictional term introduced by Dodd-Frank—"abusive" act or practice—and choosing instead to retain the option of defining it through enforcement actions.[27] Congress should not permit the Bureau to settle into a practice of relying on non-APA rulemaking methods that deprive members of the public of the opportunity to participate in the development of the rules that will govern them.

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21. Office of Inspector General, "Work Plan," May 5, 2014, p. 12, http://www.federalreserve.gov/oig/files/OIG_Work_Plan.pdf.
22. Office of Management and Budget, "Circular A-4," September 17, 2003, p. 17.
23. For example, see the critical analysis of the Bureau's approach to data interpretation in a number of regulatory areas in, Adam C. Smith and Todd Zywicki, "Behavior, Paternalism, and Policy: Evaluating Consumer Financial Protection," Mercatus Center at George Mason University Working Paper No. 14-06, March 2014, pp. 17-26.
24. Todd Zywicki and G. Michael Flores, in reviewing the Bureau's white paper on overdraft fees, identified a number of holes in the Bureau's analysis and cautioned that a failure "to recognize these limits of the white paper could lead to subsequent regulatory and enforcement actions that may be harmful to consumers and the economy." G. Michael Flores and Todd J. Zywicki, "Commentary: CFPB Study of Overdraft Programs," November 2013, http://mercatus.org/publication/commentary-cfpb-study-overdraft-program.
25. For a number of examples of this phenomenon, see John D. Graham et al., "Mercatus Releases Five Academic Articles in the Harvard Journal of Law and Public Policy," May 13, 2014, http://mercatus.org/expert_commentary/mercatus-releases-five-academic-articles-harvard-journal-law-and-public-policy.
26. Bureau of Consumer Financial Protection, CFPB Bulletin 2013-02, March 21, 2013, http://www.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf. The Bureau's guidance effectively regulates automobile dealers, a group over which the Bureau does not have authority. Dodd-Frank § 1029 (codified at 12 U.S.C. § 5510).
27. Hester Peirce, "CFPB Knows Abuse When It Sees It," March 29, 2012, http://mercatus.org/expert_commentary/cfpb-knows-abuse-when-it-sees-it. Director Cordray suggested that "there is some guidance that we have provided around that set of terms—unfair, deceptive, and abusive acts or practices—in our examination manual, which is public and available on our Web site. And institutions have every opportunity to look carefully at that and to inquire with us and ask questions about anything that is unclear to them." "The Semi-Annual Report of the Consumer Financial Protection Bureau," Hearing Before the House Committee on Financial Services, 112th Cong., 2d Sess. 15 (March 29, 2012) (testimony of Richard Cordray, Director, Bureau of Consumer Financial Protection). Using enforcement manuals to proscribe conduct is another form of backdoor rulemaking. Institutions should not be forced to read examination manuals to determine what their legal obligations are.

STATUTORY FLAWS

Dodd-Frank's grant of authority to the Bureau allows the agency considerable discretion. Constraining this discretion in a number of areas, particularly in its discretion to spend penalties and its power to collect data, could help the Bureau to focus its efforts in productive ways and avoid taking actions for inappropriate reasons.

Dodd-Frank created a "Consumer Financial Civil Penalty Fund" into which penalties assessed by the Bureau are deposited. The Bureau is authorized to use this fund to pay victims or "for the purpose of consumer education and financial literacy programs."[28] The Bureau selects the recipient programs. The Bureau's ability to spend the penalty money it collects stands in contrast to standard practice, which is for agency penalties to go to the Treasury's general fund. The basis for this standard practice is sound: an agency that is permitted to apply penalty money for its own purposes has an incentive to levy higher penalties. The Bureau can effectively increase its budget by levying fines, and this is exactly what we see happening. By the close of fiscal year 2013, the Bureau collected $81.5 million, of which only $13 million went to directly compensate consumers.[29] If the Bureau's enforcement policies are perceived to be driven by its own interest in increasing the size of its civil penalty fund, the Bureau's legitimacy will be compromised.

Another area in which the Bureau's authority needs further constraints is data collection. To date, the Bureau's approach to data collection has been extremely expansive. As a consequence, the Bureau has access to sensitive information about consumers. For example, the Bureau collects data on the vast majority of credit card accounts, even though a much smaller sample size would be sufficient. George Mason University econometrician Thomas Stratmann demonstrated recently demonstrated that "a one percent sample will achieve the CFPB's goals while alleviating concerns about consumer privacy and costs."[30]

The Bureau's data collection efforts are not limited to consumers' credit card information. Last month, the Bureau's partner in another collection effort—the National Mortgage Database—announced that, starting next week, the database is being expanded to include a range of new information about mortgage borrowers, including their religion, major life events, detailed financial information, social security numbers, and employment records.[31] The database will be accessible to, among others, volunteers and interns and "the Consumer Finance [*sic*] Protection Bureau."[32] These large-scale collection efforts should not be undertaken without careful consideration of the potentially serious implications for the consumers whose data are being collected.

CONCLUSION

The flaws in the Bureau's design impair its ability to operate effectively for consumers. Although more fundamental reforms are needed, incremental reforms will help the Bureau to set appropriate priorities and seek relevant comments before acting. Making the agency more accountable, more transparent, and more focused will also make it more effective at ensuring that the financial system is serving the needs of consumers.

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28. 12 U.S.C. § 5497(d).
29. Bureau of Consumer Financial Protection, "Strategic Plan, Budget, and Performance Plan and Report," March 2014, p. 22, http://www.consumerfinance.gov/f/strategic-plan-budget-and-performance-plan-and-report-FY2013-15.pdf.
30. Letter from Thomas Stratmann to Scott Garrett, Chairman, Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee, January 23, 2014, p. 1, http://mercatus.org/sites/default/files/StratmannCFPBStatisticMethods.pdf.
31. For a description of the changes, see Hester Peirce, "National Mortgage Database: Good for Regulators, Bad for You," Real Clear Markets, May 7, 2014.
32. Federal Housing Finance Agency, "Privacy Act of 1974; System of Records," 79 Federal Register 21,458, April 16, 2014, https://www.federalregister.gov/articles/2014/04/16/2014-08566/privacy-act-of-1974-system-of-records.