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The Regulation Shell Game

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I think everyone has seen versions of this game. The street-corner con artist puts a pea under one of three cups and then whirls them around with speed and deception, while the "marks" bet on the ultimate location of the pea. Evidently there is enough profit in this enterprise to guarantee new entrants over time. This is the game that is being played out in real time by Christopher Dodd, the lame duck chair of the Senate Banking Committee, and his Republican counterparts as they try to forge a compromise that will lead to a new regulatory architecture for the financial system. The particular pea in question at the moment is consumer protection.

In the early proposals from the Senate Banking Committee the creation of an independent Consumer Financial Protection Agency (CFPA) was a centerpiece of the proposed Restoring American Financial Stability Act. The draft bill also proposed to strip the Federal Reserve of its regulatory authority over financial institutions and its role in consumer protection so it could focus on its primary role--monetary policy.

Then the lobbyists got in the game, the Republicans on the Banking Committee got cold feet, the Fed got some game and the pressure rose. Clearly there is a great political game playing out, and the lobbying and logrolling are intense. As of November more than 1500 lobbyists had registered to work on this proposed legislation. Everyone from payday lenders to major financial institutions, small community banks, insurance companies, credit card companies, retailers, car dealers, telephone companies, real estate companies, credit unions, mutual funds and hedge funds have talked their game on capital hill.

The compromise that seems to have been arrived at is that we will have a CFPA but not as a stand-alone entity. It would be located in some other agency that has a consumer protection role--but with assurances that it will be independent and have adequate funding to carry out its mission. First it was proposed to be an agency within Treasury, then the FDIC. In the latest go-round rumor has it that the new CFPA would be located in the Fed. More important, Sen. Dodd and his colleagues are now proposing that the Fed have supervisory authority over the 23 largest financial institutions--those with more than $100 billion in assets. All other bank holding companies would be supervised by a new agency of the Office of the Comptroller of the Currency or the FDIC.

In this version the Fed would be a super regulator with responsibilities for consumer protection, the largest systemic institutions and monetary policy. What gives? In an earlier column I argued that there is some logic to the consolidation of consumer financial protection in one agency because it does tend to fall between the cracks under the current fragmented system.

Lobbyists, Republicans and many others have expressed concerted opposition to the creation of a new powerful consumer protection bureaucracy. The current negotiations over where to hide the pea seem designed to blunt that. In particular, some of the Senators on the Banking Committee are justifying the Fed as the likely home of the CFPA because, they argue, it is the most politically independent organization and already has responsibility for writing disclosure rules for consumer financial products. Indeed, Chairman Bernanke gave an impassioned defense of the Fed's role in consumer protection last spring.

The real battle in the Banking Committee is not over rule writing but over enforcement. The Fed's approach to consumer protection has been focused, correctly in my view, on consumer education and disclosure rules--though it has to be said that the Fed dropped the ball badly on executing its approach to consumer protection. Financial literacy and good disclosure rules are the best weapons against financial abuse. But there are those who think that powerful enforcement is the key and that a powerful agency, rather than an educated consumer and market discipline, is needed to prevent abuse.

Consumer protection is important, but it is something of a sideshow in the financial crisis. Much more is at stake in the proposals to address systemic risk and the regulation of the large financial institutions. This is what brought the financial system to the brink of collapse. There is a legitimate concern that this shell game over the CFPA could derail the most important aspects of financial reform and politicize the Fed.

Consumer protection is inherently highly politicized because there are so many constituents--both businesses and consumers. The current logrolling circus should provide enough evidence that politicians can put tremendous pressure on regulators to protect consumers and business interests in particular ways without concern for the larger consequences. If that regulator is the Fed and is also responsible for systemic regulation and monetary policy, we risk damaging one of the most important and independent institutions in our financial system.

It also is likely that the legislation being hammered out will limit the Fed's authority in another important way. Both the House and Senate versions propose limitations on Section 13(3) authority, a provision that allows the Fed to lend to corporations, individuals and partnerships under "unusual and exigent circumstances." There are mixed views on this issue. On the one hand 13(3) authority empowers the Fed in responding to crises. But it also can blur the distinction between fiscal and monetary policy because it gives the Fed the ability to allocate capital to certain sectors like housing--decisions that should properly be made by the Treasury. When the Fed unwinds those positions it will be subject to lots of second-guessing and possibly political pressure.

The good news from this messy process is that the most important elements of financial reform--important for limiting the risk of future meltdowns--are likely to emerge. There is general agreement among legislators on the need for systemic regulation and oversight and for a resolution facility for insolvent systemically important institutions. I suspect that for most people the details of financial regulation are "wake me when its over" issues. The process is not pretty to watch, and it's not over until it's over--but it is very important for our future.

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