Effective consumer protection in financial services: a new model

“Banks aren’t changing quickly enough and the regulatory community is over-reacting. There is need for these two deeply entrenched positions to be aired as opposed to the continuous mud-slinging that has been going on.” – Bank executive

“Consumer protection is already a very important board-level issue for bank policy and risk management. Directors are worried about the emerging regulations. Boards should be engaged on the consumer protection topic.” – Bank director

“At the same time, there is something fundamental that does need to change within the industry – a move from a focus on what’s important to business and more to what’s important to customers. Financial results are an output of that. People refer to this as culture, but it’s much more – it’s about the business model. A genuine focus on customers and customer outcomes – that is a huge change that the industry needs to go through. That’s part of the solution.” – Bank executive

Introduction

Consumer protection has gained new importance since the financial crisis that began in 2008, for financial institutions’ business models, regulatory oversight, and consumer behavior. Consumer protection measures are very important for preserving consumer welfare in complex financial markets where making good decisions is both difficult and consequential. At the same time, new policies to enhance consumer welfare, if not properly structured, can be ineffective and result in outcomes not intended by policy makers as product providers modify their practices and strategies. It is critical that policy makers and financial providers collaborate now, in the early days of precedent-setting consumer protection policies, in a trusting dialogue to achieve common objectives while minimizing unintended consequences.

With the passage of the Dodd-Frank Act in 2010, a new regulatory agency charged exclusively with ensuring consumer protection – the Consumer Financial Protection Bureau (CFPB) – came into being. The CFPB spent its first year pursuing regulatory and enforcement actions that it was obliged to implement by its founding Act in the areas of credit cards, mortgages, payday loans, and other financial product markets. It now has much greater discretion to choose its area of focus, with a mandate that is virtually unprecedented in regulatory history.

But consumer protection issues are not limited to the CFPB. The Office of the Comptroller of the Currency (OCC) and the Federal Reserve also have consumer issues within their mandates. Financial institutions acknowledge the importance and benefit of new consumer protection measures, but the distributed nature of oversight across multiple agencies has created a degree of confusion and inefficiency in the early days of renewed focus on consumer issues.

1 All discussions were held under a modified version of the Chatham House Rule that encourages sharing of perspectives but absolutely forbids attribution to individuals or institutions. All comments from participants are italicized.
The enforcement actions and fines so far have been significant, motivating financial institutions to avoid such penalties in the future through changed practices. In 2012 alone, the CFPB levied fines of $425 million to be refunded to consumers, and $101 million in civil penalties. And some of the largest recent penalties for consumer issues have originated from OCC and Federal Reserve actions.2

The effects of enhanced consumer protection measures are important and complex. They affect financial institution business models, product design and distribution, regulatory focus and actions, and consumer behavior. At this time of sharper consumer focus, there is a high degree of uncertainty regarding important precedent-setting supervisory and enforcement actions. Regulators are developing new approaches as they enhance oversight and navigate interactions with other agencies that possess overlapping mandates. Financial institutions are seeking clarity on public policy objectives and how they will be implemented in practical terms. And consumers are increasingly affected both by the micro-effects of new product designs and distribution practices and the macro-effects of product availability as providers choose to modify their strategies.

Enhanced consumer protection is also an important new direction for public policy and the financial services industry. Consumer welfare can be significantly enhanced through new oversight and practices. At the same time, unintended consequences of some actions by both the private and public sectors can result in consumer detriment and inefficiency. At this point in the process it is critical for the public and private sectors to collaborate to develop a unified approach to enhancing consumer protection in a way that provides a net benefit to consumers, accomplishes important public policy goals, and accounts for the myriad effects on behavioral responses from both financial institutions and consumers of financial products.

In this paper, we will walk through the most important considerations for enhancing consumer protection and propose a collaborative, trusting dialogue between policy makers and product providers that establishes common objectives, seeks higher ground, and results in mutually beneficial outcomes for all stakeholders. The remainder of the paper is organized around the following themes:

- Consumer protection regulation is significant
- An effective supervisory engagement model is essential
- It is critical to engage now
- Consumer protection policies must strike a balance
- A general framework for consumer protection is urgently needed
- A multi-stakeholder approach can lead the way (a proposal that we present as a separate document)

Effective consumer protection in financial services: a new model

Consumer protection regulation is significant

Consumer welfare is important. Enhanced consumer protection measures are integral to improving consumer welfare. Financial products are frequently difficult for the average consumer to evaluate and are significant in their effects on individual well-being. Unlike with some other products, financial product decisions are highly quantitative and analytical, involve long time horizons, sometimes are difficult to reverse, and can require arcane knowledge of poorly understood markets. Education and advice are available, but they are not always easily accessible or free. Finally, financial product decisions frequently involve time horizon tradeoffs that challenge individual self-control, even in the presence of full knowledge. For these reasons, a higher level of regulatory oversight of financial product markets is justified, relative to other types of product markets.

Product providers need clarity. At the same time, financial product providers require clarity, efficiency, and balance in the application of consumer protection measures, as the stakes for findings of consumer harm and the requisite fines loom large for many institutions. The new focus on product design, selling practices, oversight of third parties, and pricing structures (including product bundling) have important implications for product development, distribution, and ultimately strategic business models. In particular, there are four areas where consumer protection oversight is felt most strongly:

- **Product liability and fines.** In the past year, significant fines have been imposed by consumer agencies as a result of findings of consumer harm. In July 2012, the CFPB fined CapitalOne $210 million in its first enforcement action for marketing practices associated with credit card “add-on” products. That September it levied fines of $214 million against Discover for similar practices. And in October it levied $85 million in fines against American Express for “violating consumer protection laws at every stage of the consumer experience, from marketing to enrollment to payment to debt collection.”


- **Product design and pricing.** Consumer protection policies have directly influenced product design and pricing structures. The most recent example is the qualified mortgage and servicing regulations. By defining conditions under which mortgage underwriters will be shielded from findings of liability (including specific debt-to-income ratios, term length, closing costs, and loan officer compensation models) the new regulations will significantly affect product design and credit availability. As one commentator noted, “The final mortgage rules will dramatically change the way mortgages are written as well as access to credit.” Indeed, the CFPB has acknowledged these dynamics, “Our goal here is not only to stop reckless lending, but to enable consumers to access affordable credit. We can draw up

the greatest consumer protections ever devised, but if consumers cannot get credit, then there is nothing to protect.”  

Product design effects are also evident in product bundling, such as with checking account features, credit card offers, and financial advice offerings. As one bank executive noted, product bundling regulations can have indirect effects on consumer welfare: “When you break packages of products apart, it doesn’t look like a great deal but altogether, it’s an OK deal.” And in some cases, existing products are removed from the market through regulatory action. As one industry observer noted, “The OCC basically pushed payday lending out of our system – we just said we’re not going to have payday lending in our banks. Tax anticipation lending was distasteful and had some safety soundness concerns and the same thing happened.”

- **Compliance costs.** Compliance with new consumer regulations is one of the largest ongoing costs for financial institutions. The CFPB has been particularly active in requesting data and soliciting customer complaint information. As one industry observer noted, “I can’t recall ever seeing so many regulations hitting so quickly across such a wide spectrum of industries. It’s going to be a challenge to implement.” Compliance costs are growing rapidly as the CFPB, OCC, and Federal Reserve refine sometimes unclear and overlapping mandates across institutions and product areas. In certain situations, agencies have beneficially revised their approaches based on industry reaction, as in the case of the CFPB’s delayed implementation of the International Remittance Transfer Rule, which took place when providers began to exit the market in response to the burden of new reporting requirements.

- **New areas of oversight and distributed responsibility.** The governance, funding, and oversight scope of the CFPB, in particular, are without precedent. Its director is appointed by the president and confirmed by the senate, and its budget is tied directly to Federal Reserve spending, thus insulating it from congressional oversight of funding levels. Its product and organizational mandate extend into virtually any retail financial services interaction, including banks, credit unions, securities firms, payday lenders, mortgage servicing operations, credit reporting agencies, debt collectors, credit cards, student loans, auto loans, and foreclosure relief services.

The CFPB is also exploring entering new areas of oversight, including the markets for retirement savings, investments, and financial advice, as it deploys its $343 million annual budget and staff numbering in the thousands. As one bank chief risk officer (CRO) commented, “They [the CFPB] have asked for every agenda, meeting material and minutes for just about every committee meeting we have for two years and going forward.” And, as an industry observer noted, “What the CFPB might target next is unclear, but the agency has been on a data-collecting whirlwind in 2012. It has been gathering consumer

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Complaints on a variety of products, including credit cards, mortgages, student loans, and has sought highly detailed information from lenders.”

Consumer protection is not the exclusive mandate of the CFPB, however. The OCC and the Federal Reserve also have consumer issues within their mandates. The OCC is charged with ensuring the safety and soundness of banks, as well as ensuring fair access and equal treatment of bank customers.7 And the Federal Reserve retains oversight for several consumer-oriented regulations, including the Community Reinvestment Act. In fact, some of the largest recent penalties for consumer issues have originated from OCC and Federal Reserve actions, such as the recent $8.5 billion settlement with 10 banks to remedy improper mortgage foreclosure processes.8

To improve the efficiency and clarity of consumer protection measures, regulatory agencies will need to coordinate their mandates and oversight practices and banks will need to create efficient engagement models for interacting with multiple agencies that oversee consumer issues.

**An effective supervisory engagement model is essential**

Consumer protection responsibilities have been distributed through multi-agency statutes, but the day-to-day organizational practices continue to develop and evolve. The CFPB has the broadest mandate across banks above $10 billion in assets, while the OCC oversees nationally chartered banks. The Federal Reserve oversees state-chartered banks that are members of the Federal Reserve System and banks at the holding company level. It also retains oversight of selected elements of consumer protection, including the Fair Housing Act and the Community Reinvestment Act.

Banks are experiencing day-to-day challenges arising from this complex mosaic of consumer protection supervision. Many who are engaged daily with the authorities have cited areas where improvement is urgently needed:

- **Reconciling supervisory mandates and operations.** Financial institutions need clarity on the lead consumer agency responsible for specific areas of consumer welfare by product, practice, and organization. Banks and supervisors also need clearly established policies for coordinating both between agencies and across supervisory and enforcement functions. In particular, clear rules of engagement are needed to stipulate when agencies will use the findings of their counterparts as valid input to their investigations. Under current practices, banks are experiencing inefficient double-jeopardy scenarios across multiple agencies and functions. As one bank executive recently noted, “You can imagine if one of your primary regulators has been going through months of investigation and then that they dismiss the findings of the exam team on the same issue – it’s insane.” There also appears to be growing competition in a supervisory “race to the top.” As another executive noted, “The OCC and other regulators are worried about being criticized by the CFPB for not being tough enough.” In the short term, agencies have developed memoranda of understanding to outline short-term rules of engagement on selected issues, but more needs to be done to

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7 The OCC also oversees the enforcement of the Fair Lending provision within the Fair Housing Act.

develop an efficient long-term engagement model. The financial industry can help supervisors develop an efficient and clear operational model that minimizes duplication and the potential for addressing the same issues through multiple venues.

- **Recognizing tradeoffs between consumer protection and other policy objectives.** A second issue involves balancing dual supervisory mandates: ensuring consumer protection while also accounting for effects on the safety and soundness of banks and related macroeconomic objectives. Multiple supervisory authorities with narrowly scoped mandates can sometimes propel banks toward one objective, while not accounting for the collateral effects of moving away from a related objective. Developing a shared view of policies in which supervisory actions affect multiple objectives is critical to the banking industry, its supervisors, and the wider economy. The tradeoff between more stringent mortgage underwriting standards and the effect on capital availability is a recent example. As one director noted, “We’re pretty concerned about the regulatory perspective. CFPB ranks very high on what we’re concerned about, particularly what lines of businesses we want to be in, including the mortgage business. The mixed messages from regulators are pretty incredible – on the one hand it’s lend, lend, lend and on the other it’s these large fines for lending practices.”

**It is critical to engage now**

It is critical that the financial industry engage now on the direction, priorities, and methods of consumer protection policies to ensure that the private and public sectors find common ground, achieve important consumer protection goals, and make progress efficiently and knowledgeably, by taking the following measures:

- **Developing a shared approach.** The financial industry can help develop higher-level principles and practices of ensuring consumer protection and engage the supervisory community in articulating a common set of objectives and methods to shape the future of consumer protection supervision. It is clear that consumer protection oversight is here to stay, and the approaches of the CFPB, OCC, Federal Reserve, and others charged with oversight of consumer issues are still evolving. As a result, the industry and supervisors have a brief opportunity to collaborate in developing effective, efficient approaches that can achieve common objectives.

- **Understanding future direction.** To date, the CFPB has been engaged primarily in implementing product oversight in areas where it is obligated by Dodd-Frank directives. Increasingly, however, the Bureau will be free to use its discretion to determine which products, customer segments, and practices it feels are most urgently in need of its attention. Consequently, the future direction of the CFPB may become less predictable than it has been. Industry engagement with consumer protection regulators now can help clarify and inform future areas of priority. The OCC and Federal Reserve are also re-examining their consumer welfare priorities across customer segments, products, and practice areas.

- **Engaging on leadership transition.** The current CFPB director’s recess appointment term ends in 2013, although he has recently been re-nominated by the president for a new
full term. At the same time, some Congressional leaders and parts of the finance industry have proposed a new multi-person commission to replace the single director role at the head of the CFPB, thereby diversifying its leadership. Further uncertainty arose recently when the validity of the director’s recess appointment was called into question by a related ruling on the president’s appointments to the National Labor Relations Board. This environment creates an ideal time for stakeholders to engage on the future leadership and governance of the bureau, thereby influencing the direction and methods of consumer protection policy.

**Consumer protection policies must strike a balance**

There is considerable confusion and disagreement among financial institutions, regulatory agencies, and consumer advocates about the objectives and best methods for ensuring consumer protection, and about the relative responsibilities of buyers and sellers in the market for financial products. On one hand, some have decried regulatory over-reach. As one bank executive commented “Caveat emptor does not exist anymore; businesses are now responsible for customer decisions.” At the other end of the spectrum, many have noted the unique nature of financial markets. According to one bank executive, “Industry has been operating in a caveat emptor environment and many of the “emptors” cannot be caveat. If you buy a bad pie in the shop, 99% of people won’t do it again, but for insurance/banking products, you never really find out it’s a bad deal until it’s too late.”

Still others have outlined middle ground where customers, the financial industry, and its regulators need to meet. In the words of one observer, “I think the customer ultimately has to be responsible for decisions. But the industry needs to be accurate, simple and paint a fair picture of the options for the customer. Regulation is only part of the answer. People need to have the ability to make informed decisions on their own.” It is clear that a middle ground needs to be developed between buyer and seller. But as yet there is not a shared understanding of consumer protection objectives, methods, and practices by the industry, its regulators, and consumer advocates.

**Key sources of consumer protection.** Actions to ensure consumer protection can have both direct and indirect effects on consumer welfare through the reactive behaviors of consumers and financial providers. Ideally, supervisory agencies will collaborate with the financial industry to develop the best approach and deepen their collective understanding of the potential for direct and indirect effects. This approach would identify which forms of consumer protection are most effective for each circumstance, how they can best be configured to achieve desired outcomes, and what the appropriate balance would be between a range of voluntary and mandated practices. Sources include:

- **Traditional product-based sources.** Through product design principles, labeling, transparency measures, and information disclosure, financial services firms can enhance and ensure consumer protection.

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Sales- and distribution-based sources. Suitability principles, fiduciary standards, licensing requirements, and sales and marketing guidelines all contribute to consumer protection. The provider’s product and sales organizations are principally responsible for these measures, with significant involvement of supervisory authorities.

Consumer-based sources. Consumers may draw on their own knowledge, skills, and financial literacy to protect and enhance their own welfare.

Third-party sources. Intermediary organizations (e.g., independent personal finance publications, advisors) may provide education, ratings, evaluations, user reviews, pricing, and descriptive product information.

Regulators and supervisors. In addition to voluntary actions to improve consumer welfare, regulators and supervisors also create and enforce many statutes that directly safeguard consumers through market intervention. As an example, the CFPB intends to intervene preemptively to address issues in product design, selling practices, and detrimental consumer behavior. Supervisors’ proposed remedies include consumer warnings, product and sales prohibitions, and fines levied after product introduction, with long look-back periods for behavior found to be at fault.

An optimized approach to consumer protection will also identify the potential for indirect effects on consumer welfare, and whether their magnitude may substantially reduce net welfare for some consumers.

Detrimental side effects of some consumer protection actions:

- Challenges to innovation. Enhanced consumer protection regulation may constrain innovation both directly, through the imposition of design principles, and indirectly, in the form of slower introductions of new products. The result could be a more slowly evolving, simpler array of products.

- Changes in customer behavior. Consumer protection measures usually result in advantageous changes in consumer behavior. However, when the balance of responsibilities is redistributed between buyer and seller, there may also be detrimental behavioral responses, particularly in the area of lending, where more forgiving policies may lead to higher delinquency rates. For example, there has been a marked increase in strategic defaults on non-recourse mortgages in which the long-term costs of default borne by the borrower are less than the benefit of writing off large amounts of debt. In the longer term, de-stigmatizing debt default may have profound effects on lender underwriting behavior, the availability of capital, and required risk-adjusted returns charged by lenders. There is also the risk that consumers may reduce their degree of vigilance when purchasing a financial product that they believe has the implicit approval of a government-sponsored consumer safety agency.

- Difficulty serving traditionally underserved populations. Providers are able to make certain products available to lower-value customers through activity-based pricing and
cross-subsidization. In some cases, consumer protection guidance can constrain pricing flexibility such that the institutions decide to exit those underserved markets.

- **Long-tail liabilities.** Product liability with long look-back time frames creates large potential liabilities for the industry. As one CRO recently summarized, “[The costs of litigation] are colossal if you add them up across the industry. There is more to come, and it could be devastating.” These legacy costs present challenges as financial institutions move ahead with new business models and new product development. Ex ante regulation of allowed product types may have its drawbacks, but ex post findings of consumer detriment with long look-backs can also degrade banks’ safety and soundness.

**A general framework for consumer protection is urgently needed**

A shared general framework for ensuring consumer protection in financial markets is urgently needed both by private industry and its consumer protection supervisors. The framework would act as a common guide to financial institutions, executive management, boards, supervisors, and functional/product leadership. It would begin – at the highest level – with consumer protection objectives and general principles to uphold. It would then develop specific guidelines and issues to consider at each level – by supervisors, boards, executive management, and specific functions and lines of business (e.g., marketing, sales, product management, risk management). It would offer a common construct for financial organizations to manage their business, engage with boards on governance oversight, and engage with consumer protection agencies on compliance and business performance. It would also provide enduring business model guidance to ensure that financial services businesses, as they grow and evolve, are pursuing sustainable, high-value activities with their target customers.

A shared framework would enable the fulfillment of public policy objectives, clarify the approach for financial institutions and their supervisors, and form common ground where consumer welfare could be enhanced most effectively.

**Components of a general framework:**

- Consumer protection principles and objectives
- A supervisory engagement model
- An articulation of board role and practices
- Executive management role and practices
- Functional roles and practices (e.g., marketing, sales, product, risk management)
- Expectations of customers by segment and circumstance
- Risk identification and management

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Benefits of a general framework:

- A pro-active, common approach to addressing consumer protection risks and benefits
- A clear organizational model of best practices and risks by business function
- An engagement model for boards of directors, supervisors, and executive management
- A vehicle for finding common ground and developing optimal approaches
- Reduction of risk from consumer protection liabilities
- Development of long-term sustainable business models
- Competitive advantages over financial institutions less engaged on consumer protection
- Reputational benefits from taking a leadership position on consumer protection

Tapestry Networks believes that if a group of leaders charged with delivering enhanced consumer protection comes together to explore key issues and define best approaches, their findings will have the potential to move the industry in the desired direction effectively and efficiently, with minimal side effects.

We are currently evaluating a multi-stakeholder initiative that would clarify regulatory intent and practice, provide a vision of beneficial outcomes that both providers and supervisors could embrace, and discover methods for achieving superior outcomes in the most efficient manner. A companion document outlines the details of this proposed approach.

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About Tapestry Networks

Founded in 2002, Tapestry Networks, a private company, seeks to advance society's ability to govern and lead. We have formed dozens of networks of private- and public-sector leaders to address complex issues such as corporate governance, regulation of the financial sector, and drug development and access.

Tapestry's financial services practice was founded in 2008. Currently, it includes two premier global industry networks. The Bank Governance Leadership Network (BGLN) is now in its fifth year. It provides unique opportunities for candid dialogue among non-executive directors and executives from over 25 leading global banks, regulators, supervisors, and policymakers on the critical challenges facing the industry. The BGLN includes over 250 leaders from the banking and supervisory communities. The Insurance Governance Leadership Network (IGLN) was founded in 2012; it provides the same opportunity for non-executive directors and executives from approximately 20 leading global insurers to engage in dialogue on the critical challenges facing the industry, among themselves and with members of the regulatory and supervisory community. In total, over 550 industry leaders engage in the BGLN and IGLN.

In addition, Tapestry worked with the Group of Thirty (G30) to create its influential report Toward Effective Governance of Financial Institutions, an effort that testifies to Tapestry’s ability to coordinate a large, multi-stakeholder project that produces meaningful results.

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