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Why More Consumer Protection When Too Much Led To Crisis?

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Posted 01:11 AM ET

Chris Dodd, chairman of the Senate Banking Committee, has announced his intention to move ahead on his financial reform plan without the support of the panel's senior Republicans.

Dodd's desire to create a new consumer finance protection agency is a major reason for this lack of support. Republicans, and moderate Democrats, are right to oppose this new agency. As designed, it would increase the likelihood of future crises rather than reduce them.

Advocates of the new agency argue that bank regulators have placed too much priority on bank safety and soundness, at the expense of consumer protection. After almost 150 bank failures and trillions of dollars of assistance to the financial sector, the problem would seem to be that there was not enough emphasis on safety and soundness, rather than too much.

Proponents of creating a consumer financial protection agency assert that failures in consumer protection were behind the financial crisis. Nothing could be further from the truth. A housing bubble, driven by easy credit and a mistaken belief that housing prices would rise forever, was the cause of the crisis.

The severity of the housing boom and bust was not the result of predatory lending practices. Quite the opposite: It was the result of credit being too friendly.

For instance, we know that the No. 1 determinant behind mortgage foreclosure is negative equity on the part of the borrower. Yet this new agency would have no power to increase down payments.

Under the guise of consumer protection, bank regulators spent much of the last decade urging banks to expand mortgage credit. Researchers, such as Jeff Gunther at the Dallas Federal Reserve Bank, have found that the more Community Reinvestment Act lending done by a bank, the worse its safety and soundness.

Removing enforcement of lending regulations, such as CRA, from the bank regulators eliminates the ability of regulators to balance those efforts against the safety and soundness of our financial institutions. Policy should be based upon what we know works, or does not work.

Separating safety and soundness from consumer protection has been tried before in the context of Fannie Mae and Freddie Mac.

From 1992 to 2008, the Department of Housing and Urban Development enforced the housing goals for these companies, while the Office of Federal Housing Enterprise Oversight monitored their financial health.

Unsurprisingly, HUD over the years continued to push Fannie and Freddie to take on ever more risk, without regard to their financial health. The result has been a taxpayer-funded bailout of these companies that will cost in the hundreds of billions.

Even Sen. Dodd and Rep. Barney Frank, chairman of the House Financial Services Committee, recognized the dangers in having these functions separate.

In 2008, Dodd and Frank authored legislation that combined these previously separate functions into a new regulator for Fannie and Freddie. Oddly enough, Dodd and Frank are now at the forefront of pushing for these functions to be separated in the case of banks.

Advocates for separating prudential regulation from consumer protection for banks should explain why they support the opposite framework for Fannie and Freddie.

Perhaps this inconsistency is explained by the special treatment Fannie and Freddie always seem to receive. Despite all the benefits of a consumer finance agency, as promised by its promoters, both Fannie and Freddie are explicitly exempted from the agency's oversight.

As if that is not bad enough, Wall Street is also exempt from this new agency. Oversight of Wall Street will remain at the Securities and Exchange Commission, an agency plagued by failure.

Nor do the special exemptions end there. All the cheerleaders of the housing bubble, the real estate agents and homebuilders, who promised housing as a guaranteed investment, are also exempt. Almost everyone who had anything to do with the financial crisis will not be covered by this new consumer protection agency.

But then the intention of this new agency is not to prevent future financial crises, or to protect the taxpayer. The intention of the agency is to expand the reach of the trial bar and federal regulators over financial products offered by non-banks, such as check cashiers and payday lenders.

Whatever one's opinion as to the value of these nonbank financial companies, we can generally agree that they weren't behind the financial crisis. In addition, these entities are already covered by the Federal Trade Commission's authority to eliminate unfair and deceptive practices.

Unfortunately, efforts to create a new consumer finance agency distract from fixing the real flaws in our financial system. Washington should abandon this effort at rewarding special interests in the trial bar and focus its efforts on protecting the taxpayer.

Rather than moving so-called consumer protections, such as CRA, to a new regulator, Congress should repeal outright government efforts to push risky lending.

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