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# A Specter is Haunting the Financial Industry - The Specter of the Global Financial Crisis: A Comment on the Imminent Expansion of Consumer Financial Protection in the United States, the United Kingdom, and the European Union

Daniel Lamb

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# A Specter is Haunting the Financial Industry – The Specter of the Global Financial Crisis: A Comment on the Imminent Expansion of Consumer Financial Protection in the United States, the United Kingdom, and the European Union

**By Daniel Lamb**

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## I. SYNOPSIS

This Comment explores the regulatory fallout from the global financial crisis. Across borders, policy makers are united in their conviction to reconcile the perceived failures of their predecessors to foresee and prevent the crisis, the effects of which show no signs of abating. A critical component of what caused the crisis was the inability to correct failures in the consumer credit market, specifically in subprime mortgages. Exacerbated by an influx of capital and a generally weak regulatory environment, this market failure manifested itself forcefully through a tidal wave of defaults in the American mortgage market that sent shock waves around the world. Unanimously, governments have responded with structural changes to their regulatory regimes with a renewed emphasis on consumer financial protection. While developments continue to be in flux, this comment explains how the structural changes, as currently understood, will usher in an unprecedented myriad of laws, rules, guidelines and regulations to be imposed on financial institutions around the globe.

## II. INTRODUCTION

The global financial crisis, in exposing fatal flaws in modern finance, dealt a severe blow to the prestige and power of Western governments.[1] The devastating contraction in liquidity brought on by the crisis begot a deep, lingering, and world-wide recession.[2] Americans in particular, having lost $11 trillion in household wealth, have experienced lasting hardship in the wake of the crisis.[3] For a generation the world will be forced to grapple with an economic

1. Roger C. Altman, *The Great Crash: A Geopolitical Setback for the West*, FOREIGN AFFAIRS (Jan./Feb. 2009), www.foreignaffairs.com/articles/63714/roger-c-altman/the-great-crash-2008 (discussing how the financial and economic crash of 2008 remains a "major geopolitical setback for the United States and Europe").

2. Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States XV-XXVII (Jan. 2011), available at http://www.gpoacuss.gov/fcic/fcic.pdf.

3. *Id.* at xv. Moreover, twenty-six million Americans are unemployed, under-employed, or have given up looking for work; and eight and a half million Americans have, or are in the process of, losing their homes in foreclosure proceeding. *Id.*

catastrophe that was avoidable, "the captains of finance and *public stewards of the financial system* ignored warnings and failed to question, understand and manage evolving risk within a system essential to the well-being of the American public."[4] It should come as no surprise then that the financial industry is in the midst of a regulatory revolution.

Reforming the financial system in order to prevent another disaster in administrative oversight has been the focus of governments around the world, but especially in the United States, the United Kingdom, and the European Union.[5] Notwithstanding the complexity and profusion of government publications on the topic, the roots of the global financial crisis are elementary: consumers, in mass, borrowed in excess of what they could afford, leading to defaults in mass, which blew crippling holes in the balance sheets of financial institutions, (i.e. banks), which starved the economy of cash.[6] The massive failure in the consumer credit market, which precipitated the crisis, has brought the issue of consumer financial protection to the forefront in the United States and United Kingdom that led to the creation of a government agency devoted solely thereto.[7] In addition, the fifty American states and the European Union stand to have a lager role in the promulgation of consumer financial regulations.[8] These developments alone signal a coming

4. *Id.* at xvii. (emphasis added).

5. *See, e.g., id.* at xv ; FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS, (2009), (U.K.); EUROPEAN COMMISSION, FROM FINANCIAL CRISIS TO RECOVERY: A EUROPEAN FRAMEWORK FOR ACTION, Communication from the Commission (2008). (E.U.).

6. The mechanics of the crisis are, of course, much more complex and will be discussed in greater detail below. Still, the crisis is essentially a magnified example of what happens to a lender who issues a bad loan, absent a government bail-out.

7. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (establishing the Bureau of Consumer Financial Protection); *HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: CONSULTATION ON REFORMING THE CONSUMER CREDIT REGIME* HM TREASURY, (Dec. 2010) (discussing the creation of the Consumer Protection and Markets Authority), available at http://www,hm-treasury.gov.uk/d/consult.consumer.credit211210.pdf.

8. In addition and as explained below, the 50 states will also have increased enforcement powers.

wave of reform, but seen in light of their mandate to make right the global financial crisis, it suggest that these changes to regulatory structure will produce massive substantive changes and force banks to cope with once unthinkable government intervention.

This Comment will explore the structural changes in regulation concerning consumer financial protection in the United States, the European Union, and the United Kingdom.[9] The comment will discuss the connection between the global financial crisis and consumer financial protection in order to justify, or at least provide a basis for, these regulatory changes in consumer financial protection.[10] From this, two structural changes will be discussed: the emergence of regulators focused on financial consumer protection and independent from other financial regulators[11] and multi-level governmental regulations.[12] An analysis of the evolving regulatory regimes in Europe and America will illustrate how these structural changes will have profound consequences for financial institutions, regulators, and lawyers.

Consumer financial protection is used as an umbrella term to describe laws and regulations designed to prevent individual borrowers from taking on excessive risk.[13] In practice, consumer financial protection regulators aim to curb borrowers from acquiring loans that are unfair or deceptive, which collectively manifest into a market failure.[14] Driven by economic and social concerns, both the United Kingdom and United States make use of consumer financial protection laws.[15] The rule making and enforcement capacity of consumer financial protection regulators have been criticized as

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9. *Id.*

10. *Id.*

11. For example, the Federal Reserve in the U.S. and Bank of England in the U.K.

12. In the case of the U.K., the level issue is discussed in relation to the European Unions while in the U.S. the issue is between the federal and state governments.

13. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008).

14. *See, e.g.*, Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002) (arguing that predatory lending represents a market failure).

15. *E.g.*, Truth in Lending Act, 15 U.S.C. § 1601 (2008) (U.S); Financial Services Act 2010, §§ 2 §§ 6A(2), FSMA (2000) (U.K.).

tepid: however, because they have traditionally been under the auspices of bank regulators, who are focused on the soundness of the overall financial service sector.[16] In the United States, individual state laws on consumer financial protection have been preempted[17] by federal laws resulting in weaker regulations.[18] Legislation passed in response to the financial crisis has confronted both these issues, raising the prospects of a more robust consumer financial protection.

A focus on regulation in the United Kingdom and United States, in particular, on the topic of consumer financial protection, is uniquely appropriate. On the consumer side, household borrowing has significantly increased in both countries in recent years leaving households highly leveraged.[19] With respect to lenders, both countries have prominent and vital financial service sectors centered on two of the world's greatest financial centers in New York and London.[20] Further, and as the crisis itself demonstrates, the myriad of regulatory regimes around the world can not be understood in isolation, but rather as co-dependent institutions participating in one economy dominated by global finance and international trade.[21]

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16. Adam Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 19 (Pub. L. & Legal Theory Working Paper Series, Research Paper No. 1259406, 2008) ("[T]he safety-and-soundness mission is incompatible with consumer protection because practices that might be profitable and thus increase banks' safety-and-soundness might also be abusive and unfair to consumers").

17. *See, e.g.*, Watters v. Wachovia Bank, 550 U.S. 1, 14 (2007).

18. The net result of preemption was essentially near total deregulation because federal regulators did not act to replace state law. Elizabeth R. Shilitz, *The Paradox of the Global and the Local in the Financial Crisis of 2008*, 26 J. L. & RELIGION 173, 182-83 (2011).

19. *Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences*, McKinsey Global Institute (Jan. 2010), http://www.mckinsey.com/mgi/reports/freepass.pdfs/debt_and _deleveraging/debt_and_deleveraging_full_report.pdf.

20. New York and London have been ranked as the joint-top global financial centers. *London and New York Tied as Top Financial Centres*, BBC NEWS , (Mar. 12, 2010), http://news.bbc.co.uk/2/hi/business/8563525.stm.

21. "[F]inancial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards . . . is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability." The Group of Twenty (G-20) Finance Ministers and Central Bank Governors, *Declaration from the Summit on Financial Markets and World Economy*, (Nov. 15, 2008), available at http://www.g20.org/documents/g20_summit_declaration.pdf.

Part III of this Comment provides an overview of the global financial crisis emphasizing the increased availability of credit and the American mortgage crisis. Part IV addresses the principles of consumer financial protection. Part V utilizes these principles and frames the crisis as a market failure in the consumer credit market. Part VI addresses reform legislation in the United States and the return of state authority through the curbing of federal preemption. Part VII discusses the European Union's renewed emphasis on regulating consumer financial protection under the theory of regulatory harmonization. Part VIII discusses financial regulation in the United Kingdom, where the new government has embarked on a mission to abolish the eminent Financial Service Authority, and replace it in part, by a regulator focused on the conduct of financial institutions.

## III. THE GLOBAL FINANCIAL CRISIS

Ben S. Bernanke, who, as Chairman of the United States Federal Reserve Bank has been central and lasting figure in the response to the global financial crisis, describes recent events as such:

> This is a momentous time. During the past two and a half years, our nation has endured the worst global financial crisis since the Great Depression, a crisis that in turn helped cause a deep recession both here and abroad. During some of the worst phases of the crisis, a new depression seemed a real possibility.[22]

This Section provides a sketch of the themes and events that constitute the global financial crisis. While specific attention is given to developments in the United States and the United Kingdom, the crisis can only be understood as global in scope.[23] The discussion is

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22. Ben S. Bernanke Chairman, Fed. Res., Speech At the Dallas Regional Chamber: "Economic Challenges: Past, Present, and Future." (Apr. 7, 2010) Former Prime Minister of the United Kingdom, Speech at the Labor Party Conference (Sep. 29, 2009), http://www.marketoracle.co.uk/Article13841.html .

23. "[I]t is impossible to understand this crisis without reference to the global imbalances in trade and capital flows that began in the latter half of the 1990s."

divided into three consequent phases: 1) the credit expansion that infused the global economy at the turn of the century, 2) the collapse of the American housing market and the consequent tidal wave of mortgage delinquencies, referred to as the "mortgage crisis," and 3) the global credit squeeze that threatened to usher in a second great depression.

### A. *The Credit Glut*

In the decade that preceded the crisis, the availability of consumer credit grew rapidly.[24] Referred to as the "Great Moderation" in the United States and as the "Great Stability" in the United Kingdom, the period was characterized by low inflation, low interest rates, and steady economic growth.[25] These conditions encouraged banks to lend and consumers to borrow.[26] The savings ratio among Americans fell from 6% of disposable income to below 1% and the total debt–to–disposable income ratio rose from 75% to 120%.[27] Consumers increasingly relied on debt, believing that cheap credit would always be available and that the economy would continue to flourish.[28] The proliferation of debt assured that when the inevitable downturn came consumers would be forced survive while being highly leveraged.[29]

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Ben S. Bernanke, Chairman, Fed. Res., Speech at the Council on Foreign Relations: Financial Reform to Address Systemic Risk (Mar. 10, 2009).

24. Paul Mizen, *The Credit Crunch of 2007-2008: A Discussion of the Background, Market Reactions, and Policy Responses*, 90(5) FED. RESERVE BANK of ST. LOUIS REV. 531, 533-35 (Sep. 2008).

25. *Id.* at 533. Exporter nations like China sought to build up large foreign cash reserves placing a high demand on strong currencies and permitting interest rates to stay low in many developed nations because of the influx in capital. *Id.* at 533-34.

26. *Id.* at 533.

27. *Id.* at 534. The United Kingdom shows a similar patterns in saving and debt-to-

income ratios. *Id.* (Can't fix the spacing here, might be done after all the changes do to this page, Helen)

28. These conditions have led many to believe that the crisis that followed was "an accident waiting and ready to happen." A.E. Goodhart, *The Background to the 2007 Financial Crisis*, 4 J INTL ECON & ECON POLICY 331, 331-40 (2008).

29. Economic recovery would be hindered as holders of debt engaged in the painful process of deleveraging, depressing both consumer spending and job growth. McKinsey Global Institute, *Debt and Deleveraging: The Global Credit*

### *B. The Mortgage Crisis*

The phenomenon discussed above was on full display in the American housing market. As housing prices began to rise in the early 2000s, homeowners could take advantage of low interest rates and gain access the growing equity in their property by obtaining a mortgage loan.[30] Many Americans chose to cash out, which provided an immediate benefit to the economy, by increasing consumer spending, but also greatly increased individual debt levels and exposure to risk.[31] As housing prices began to slide at the end of 2006 and as the United States entered into a recession, mortgage delinquencies rose with ever increasing speed.[32] Culminating with historic highs in 2008, the tidal wave of defaults dealt the economy a devastating blow while further depressing property values and leaving many borrowers owing more on their home than it was worth.[33]

Leading up to the mortgage crisis, home loans in the United

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*Bubble and Its Economic Consequences*, January 2010. Saddled with debt, consumers are forced to spend a large percentage of their income on payments to bring down the amount of their debt, this process, referred to as deleveraging, limits the amount of money consumers can spend in the market making economic recovery more difficult. *Id.*

30. Mizen, *supra* note 24, at 534-35. *See generally* Teresa A. Sullivan, *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213, 229-32 (2006) (discussing the rising levels of consumer debt).

31. In addition to the transactional cost associated with taking out a home loan, the property also becomes subject to the possibility of foreclosure.

32. Financial Crisis Inquiry Commission: *The Mortgage Crisis*, (Apr. 7, 2010,) http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-PSR_:The_Mortgage_Crisis.pdf. The rate of mortgage delinquency varied greatly during the mortgage crisis, with California, Arizona, Nevada, and Florida experiencing rate of 16%, nearly double the seen in other areas of the country. *Id.*

33. *Id.* A standard model of mortgage default is known as the double-trigger model, where borrowers default on a mortgage when they have both negative equity, because they owe more on the house than it is worth, and they experience some sort of income shock, such as job loss, that makes it difficult to continue making payments on the mortgage. *Id.* The Financial Crisis Inquiry Commission point to rising employment during the Mortgage Crisis as the possible economic shock brining about the increase in default. *Id.*

States became highly securitized.[34] Investors were sold the rights to the principal and interest payments on home loans were pooled together and reoffered as mortgage-backed-securities.[35] These securities were held as assets by financial institutions around the world and provided the principle funding for the housing finance systems.[36] Claims in mortgage-backed-securities by foreign banks from five major advanced countries increased from $6.3 trillion in 2000 to $22 trillion by June 2008.[37] Originally valued with an AAA ranking, this glut of assets was subjected to severe devaluation in the wake of the mortgage crisis as anticipated revenue became unrealizable.[38] Banks all over the world, already highly leveraged as a result of the credit expansion, suffered a disabling attack on their solvency.[39]

As it became clear that the mortgage-backed-securities were far more risk prone than their original valuation suggested, those financial institutions, which held significant stakes therein, were forced to reconsider their balance sheets, realizing a great increase in their liabilities.[40] Like any lender who made a habit of relying on

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34. FINANCIAL CRISIS INQUIRY COMMISSION, PRELIMINARY STAFF REPORT, SECURITIZATION AND THE MORTGAGE CRISIS, April 7, 2010, http://fcic.gov/reports/ ("By 1998, 64 percent of originated mortgage loans were sold by originators to large financial institutions that package bundles of mortgages and sell the right to receive borrowers' payments of principal and interest directly to investors.").

35. Freddie Mac spearheaded the securitization movement in the 1970s in an effort to increase the amount of available mortgage capital. *See* LELAND C. BRENDSEL, SECURITIZATION'S ROLE IN HOUSING FINANCE: THE SPECIAL CONTRIBUTIONS OF THE GOVERNMENT-SPONSORED ENTERPRISES, IN A PRIMER ON SECURITIZATION 172 (Leon T. Kendall & Michael J. Fishman eds., 1996).

36. See fn 34. Banks outside the U.S. included in the top 25 holders of mortgage backed securities include Deutsche Bank of Germany, Credit Suisse and UBS of Switzerland, Barclays and HSBC of the United Kingdom and Nomura of Japan. *Id.*

37. Oliver Blanchard, *The Crisis: Basic Mechanisms and Appropriate Policies*, IMF Working Paper No. 09/80, 2009. One of the early stories of the crisis was the surprisingly large exposure of some regional German banks to U.S. subprime loans. *Id.*

38. *Id.*

39. *Id.* For example, in 2006, the value of the off-balance sheet assets of Citigroup, $2.1 trillion, exceeded the value of the assets on the balance sheet, $1.8 trillion. Id.

40. *See* Roddy Boyd, *The Last Days of Bear Stearns*, FORTUNE MAGAZINE(Mar. 31, 2008),

risky loans, banks which stood at the center of the global capital market faced the prospect of not being able to pay their bills or return their deposits.[41]

In the fall of 2008, fears of a second Great Depression were rampant as the prospect of a bank failures spread throughout the greater economy.[42] This fear reached its zenith with the collapse, and subsequent bankruptcy, of the prominent investment bank, Lehman Brothers, an occurrence widely assumed to be unthinkable.[43] Those banks sound enough to not be struggling for survival ceased to lend money in order to enable themselves to manage their increased liabilities and/or to avoid the risk of further exposing themselves to defaults.[44] As lending terminated on a massive scale and capital was withdrawn from markets, the economy was starved of its life-line and governments were forced to supplement market capital with public tax dollars in order to keep the economy afloat.[45]

## IV. PRINCIPLES OF CONSUMER FINANCIAL PROTECTION

As made apparent by the discussion above, the mass weight of defaults that plagued the American housing market from 2006 until

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http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/ (describing how the investment bank and Wall Street legend Bear Stearns collapsed as a result of loss liquidity in the market for subprime loan).

41. *See Northern Rock: Lessons from the Fall*, THE ECONOMIST(Oct. 18th, 2007,) http://www.economist.com/node/9988865 (describing British banking giant Northern Rock road to insolvency).

42. Blanchard, *supra* note 37, at 15. The crisis led to an increase in counterparty risk between banks, i.e., to an increase in the perceived probability that a bank borrowing from another bank may not be able to repay. Id.

43. Id. at 12-13. Lehman Brothers was a well-known and large bank systematically intertwined with banks and corporations around the world and financial markets, its very public failure not only froze claims against it but greatly increased the rate at which capital was pulled from the market. Id.

44. Id. at 14. Correspondingly, investors reacted by pulling from their investment from capital causing stock markets around the world to drop precipitously. *Id* at 15.

45. The U.S. Troubled Asset Relief Program, commonly referred to as TARP or the "Wall Street Bailout." *See* Emergency Economic Stabilization – Energy Improvement and Extension – Tax Extenders and Alternative Minimum Tax Relief, Pub. L. No. 110-343, 2008 HR 1424, (allows the Department of the Treasury to purchase or insure up to $700 Billion of "troubled assets," mainly mortgage backed securities).

the present played a central role in the crisis.[46] While the nature of the problem that gave rise to the mortgage crisis is far from settled, this comment argues, that the problem should be understood as a market failure in the consumer financial product market that could have been prevented through government regulation.[47] The Section begins by discussing the principles of consumer financial protection and the problems that those principles aim to address.

Regulations described as consumer financial protection aim to prevent a borrower from incurring excessive risk when acquiring a consumer credit product.[48] Such laws are intended to curb lending practices that are unfair, abusive, or predatory, and are premised on efficiency grounds being necessary due to a market failure.[49] The market failure implicated is often described as information asymmetry, where a party to a transaction is without the information necessary to act as a rational actor in the market.[50]

Consumer financial protections are not dissimilar from regulations promulgated by other governmental agencies, such as the Federal Drug Administration. Consumer credit products, like

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46. *See* Ben S. Bernanke Chairman, Fed. Res., Speech at the Federal Reserve Conference on Housing and Mortgage Markets in Washington D.C.: Housing, Mortgage Markets, and Foreclosures (Dec. 4, 2008), (stating that "housing finance played a central role in precipitating the current crisis").

47. *See* Timothy Geithner, Treasury Secretary, Written Testimony House Committee on Financial Services, March 23, 2010:

> The housing finance system clearly cannot continue to operate as it has in the past. A broad reform process of the housing finance system must be undertaken to achieve comprehensive and effective reform that delivers a more stable housing market with stronger regulation, *more effective consumer protections* and a clearer role of government with less risk borne by the American taxpayer. (emphasis added).

48. *See* Oren Bar-Gill & Warren, *supra* note 13, at 2-4.

49. *E.g.*, Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002) (arguing that predatory lending represents a market failure).

50. Oren Bar-Gill and Warren, *supra* note 13, at 2. For example, it has been argued that the Truth and Lending Act in the United States was intended to address information asymmetries that prevented consumers from reading the terms of loans and, by extension, the risks. Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 YALE J. ON REG. 181, 181-82 (2008).

prescription drugs, pose risks.[51] Of course, credit products play a crucial and positive role in modern economies by providing consumers with greater value and providing more job opportunities.[52] Ideally, credit products are offered in a free market through a contractual relationship between informed and rational parties.[53] In practice, however, this is not always the case.[54] For example, an intelligent consumer might engage in a contract because the benefits outweigh the *perceived* risk, as opposed to the *actual* risks.[55]

One may contend that the risks of credit products will drive consumers to educate themselves in order to avoid unfavorable deals. However, consumers are often prevented from attainting the understanding necessary to make a rational decision because the cost of attainting the information is too high.[56] The average consumer, who looks at a standard form contract to acquire a credit card might fail to fully understand the implications of penalty fee terms and will

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51. Oren Bar-Gill & Warren, *supra* note 13, at 3. ("Credit cards, subprime mortgages, and payday loans can lead to financial distress, bankruptcy, and foreclosure.").

52. *See id.* at 5. ("Credit can also provide a critical safety net, permitting families to borrow against a better tomorrow if they suffer job layoffs, medical problems, or family breakups today.").

53. *Id.* This ideal is based upon the freedom-of-contract principle where faith in the value of free markets enhances consumer and social welfare. *Id* at 8. ("Moreover, informed rational consumers will minimize product risk by taking optimal care. And a market populated by informed rational consumers will force manufacturers and issuers to offer a reasonable level of product risk by optimally designing their products.") (citing STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW ch. 3 (1987) (discussing cases limited to average risk)).

54. When assumptions that drive the free market break down the freedom-of-contract principle can act as "a tool used by more sophisticated parties to take consumers' money without giving value in return." Oren Bar-Gill & Warren, *supra* note 13, at 7.

55. Steven Shavell, *supra* note 53, at 52-53. For example, "An imperfectly rational consumer might underestimate the likelihood of a penalty-triggering event. This consumer, even if she is aware of the high penalties, will underestimate the risk associated with high penalties. Consequently, this consumer might obtain a credit card that is not welfare maximizing for her." Oren Bar-Gill & Warren, *supra* note 13, at 9.

56. Oren Bar-Gill &Warren, *supra* note 13, at 13. ("This is especially true with respect to modern consumer credit products. The standard credit card or mortgage contract has gotten longer and more difficult to read, and comparison among such contracts is challenging even for a professional.").

not invest the time to do so because he or she will assume that other consumers are informed and an unfair product would not be offered.[57] In other words, the consumer trusts the market to asses the product in light of its popularity and complexity.

Providers of credit are unlikely to significantly help consumers better understand the product being offered.[58] Further, lenders are hesitant to offer lower risk products, and advertise them as such for fear that competitors will do the same, negating any benefit.[59] There is also evidence that demonstrates that lenders are unable to educate consumers on how their products are safer.[60] Such circumstances, where the market assumption of the rational decision-maker fails for lack of attainable information, constitute a market failure that needs to be regulated by the government in order for the market to operate more efficiently.[61]

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57. *Id.* Consumer Reports, often very helpful with respect to physical product, are of limited usefulness in the field of credit product because the complexity, fluidity, and diversity of credit products. *Id.* at 7.

58. Shocking, I know, but sometimes a lender can educate a borrower by explaining how the product they offer is better then those offered by competitors; in such a case the seller has an incentive to educate the consumer. *Id.*

59. For example, if a bank wanted to issue credit cards without a universal-default clause, it would have to spend capital advertising the fact in order to modify consumer expectations and educate them on the risks of a universal default provision; and provided they are successful, other issuers would also offer such cards, quickly competing away any potential return on the banks advertising investment. *Id.*

60. *Id.* at 8. For example, when Citibank publicly announced to great praise that they were no longer to offer one of the most dangerous practices associated with credit cards, universal default, they began renewed the practices after only two years. Id. The chief administrative officer for Citigroup's credit card unit explained, "[w]e hoped and expected that these two points of differentiation would lead customers to vote with their feet. . . . We have been disappointed with the results we have seen so far." *Id.* at 20. (citing Eric Dash, *Citigroup Considers Repealing a Pledge, and the Slogan with It*, N.Y. TIMES, June 25, 2008, at C4 (quoting John P. Carey, Chief Admin. Officer, Citibank Credit Card Unit)).

61. While this discussion has been mostly theoretical, empirical observations drive home the point that far too many consumers, for whatever reason, do not understand consumer credit products. A 2006 study by the United States Government Accountability Office (GAO) found that "many [credit card holders] failed to understand key terms or conditions that could affect their cost, including when they would be charged for late payments or what actions could cause issuers to raise rates." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-929, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE

The conceptual framework of a failed consumer credit market is illustrated through empirical evidence in the mortgage industry, where both complexity and risk are highest among consumer credit products. For example, many consumers do not understand, or recognize, key terms in their mortgage contract.[62] A study by the Federal Reserve Board found those with an adjustable-rate mortgages exhibit alarming confusion over the operations of that credit product.[63] Further, many consumers are unaware of the relationship between interest rates established by central banks and the adjustable rate of their mortgage.[64] Such misunderstandings pose a heightened danger when what is at stake is the individual's home.

The harm posed by failures in the consumer credit market is severe and multi-dimensional. Harm done to the individual consumer is easy to identify; an individual obtaining a dangerous consumer product, of which he has inadequate knowledge, can face a total loss of savings, loss of a home, higher cost of insurance, low-credit score, and bleak retirement, all of which can be tantamount to a broken life.[65] The harm, however, is not limited to the individual but poses a systematic threat to the wider economy. Moreover, a failure in the credit market exacerbates already present social inequalities.

The different costs born by mistaken consumers of credit process

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EFFECTIVE DISCLOSURES TO CONSUMERS, 6 (2006) (utilizing evidence based on interviews consumers).

62. Macro Int'l, Inc., *Design and Testing of Effective Truth in Lending Disclosures*, Federal Reserve ii-x(2007),http:// www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf.

63. *See* Brian Bucks & Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?* 26-27, FED. RES. BD. OF GOVERNORS, FIN. & ECON. DISCUSSION SERIES (Paper No. 2006-03, 2006,) available at http://www.federalreserve.gov/Pubs/feds/2006/200603/200603pap.pdf (stating that "[b]orrowers with less income or education seem especially likely not to know their mortgage terms").

64. *Id.*; *see also* David Miles, THE UK MORTGAGE MARKET: TAKING A LONGER-TERM VIEW: FINAL REPORT AND RECOMMENDATIONS 97 (2004) (discussing borrowers' poor understanding of interest-rate risks).

65. On the effect of dangerous mortgage products, *see*, for example, Oren Bar-Gill & Warren, *supra* note 13, at 5 n.3 (quoting JOINT ECON. COMM., 2007 JOINT ECONOMIC REPORT 37-44), stating that, a subprime foreclosure results in 'loss of a stable living place and significant portion of wealth,' 'create[s] possible tax liabilities,' and 'reduces the homeowner's credit rating, creating barriers to future home purchases and even rentals.'

are numerous and very costly, not just to the individual, but, in the aggregate, to society.[66] 1.4 million people or 35% of consumers of the product, fail each year to switch credit cards after the introductory period and face a $250 fee, which implies an aggregate cost of $350 million dollars a year for a single obscure mistake.[67] Even if it were possible to calculate and determine the cost of all such mistakes associated with consumer product, that amount would not take into account the human cost of financial distress.[68]

Effects of market failures that go beyond the individual are termed negative externalities. Two such effects created by the failure in the consumer credit market are the cost of distress to others and distortion in the market.[69] Distress is felt primarily by immediate family members.[70] Children and elderly individuals living with family can be gravely affected when their households face financial distress.[71] The failure also distorts the market by artificially raising the demand for products with underestimated risks.[72] The skew in favor of demand will encourage the market to reallocate resources accordingly, but the underlying mistake in the demand will make the shift inefficient.[73] Such negative externalities increase costs for

66. Examples of cost associated with misinformation of consumer product include: penalty fees, increased rates after introductory phases, over draft charges and the cost of a lower credit score.

67. Oren Bar-Gill & Warren, *supra* note 13, at 57.

68. *Id.* at 58.

69. *Id.* at 58-64.

70. In 2001, 1.9 million children and elderly persons, who had no direct responsibility for bills, lived in households facing bankruptcy. Elizabeth Warren, *Bankrupt Children*, 86 MINN. L. REV. 1003, 1010 fig.1 (2002).

71. *See, e.g.*, Susan E. Mayer, WHAT MONEY CAN'T BUY: FAMILY INCOME AND CHILDREN'S LIFE CHANCES, 76-77 (1997) (finding that children whose parents experienced a drop in income of 35% over two years were more likely to experience lower test scores and behavior problems in the classroom); Oren Bar-Gill & Warren, *supra* note 13, at 60 (citing *Bankruptcy Reform: Hearing Before the S. Comm. on the Judiciary*, 109th CONG. 25 (Feb. 10, 2005) (statement of Elizabeth Warren) (stating that 2 ,000 households filing for bankruptcy in 2001 indicated they had to move an elderly relative to a cheaper care facility in order to deal with their financial problems)).

72. Oren Bar-Gill & Warren, *supra* note 13, at 62-63.

73. This point will be developed below in the discussion regarding the mortgage crisis.

informed and uninformed consumers alike.[74]

The pervasiveness of negative externalities should not suggest that everyone shares equally in the burden posed by failures in the consumer credit market. To the contrary, wealthy and educated individuals largely escape the dangers of credit products.[75] Moreover, evidence shows that exposure to the risk of credit product is not evenly distributed among races and other socioeconomic groups.[76] One reason for this discrepancy is that those with more education and who are better off financially are aided by the complexity of credit product while those less educated and facing financial difficulty are hindered.[77] Still, as the recent crisis demonstrates sometimes even the smartest guy in the room does not understand what he is buying and this mistake can lead to a market failure so massive as to have an impact on all socio-economic groups.

## V. THE CRISIS AS A MARKET FAILURE IN THE MORTGAGE INDUSTRY

The global financial crisis was preceded by a tidal wave of defaults in the American mortgage market that left financial institutions the world over short of the cash needed to keep the economy moving.[78] The primary driver behind this phenomenon

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74. *Id.* at 63-64 ("The higher prices that consumers must pay for safe products represent another cost of unsafe products.").

75. A lower-middle class family who experiences an unexpected rate increase on their credit card to 29.99% and takes out an ill-advised second mortgage can be subject to severe financial hardship with little possibility of recovery. *Id.* at 69.

76. *Id.* at. 64-69; see also U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF THE TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING 35 (2000), available at http://www.huduser.org/publications/pdf/treasrpt.pdf (noting that "black borrowers accounted for 19% of all subprime refinance loans but only 5 percent of overall refinance mortgages"); John Leland, *Baltimore Finds Subprime Crisis Snags Women*, N.Y. TIMES, Jan. 15, 2008, at A1 (citing a 2006 survey by Prudential Financial).

77. Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 725-27 (2006) (discussing how the increased complexity of loan structuring can help or hurt consumers depending on their sophistication).

78. The fact that banks in Düsseldorf, Germany were exposed to the subprime market to the tone of billions under the impression such investments were AAA rated and that financial intuitions around the world were so leveraged that they were unable to deal with the shock dealt by the subprime defaults are outside the

was the subprime mortgage loan, a credit product designed primarily for lower income borrowers. While one can not dismiss the element of individual irresponsibility, where borrowers and lenders alike made poor risk assessments leading to poor financial outcomes, the massive scale of defaults and the disabling blow to the global economy make the need for reform more than apparent.[79] This Section argues that product complexity, securitization, and moral hazard within the market for subprime loans conspired to misinform consumers and artificially inflate demand for subprime mortgages.[80]

The prevalence of subprime loans in the mortgage market sharply increased over the past decade.[81] As discussed above, a boom in the mortgage industry coincided with the increased availability of credit throughout the economy. Generally, subprime mortgages offer risk prone borrowers a loan with significantly higher upfront costs, fees and interest rate.[82] In order to make such a product marketable in spite of the increased costs, it is offered along with appealing, yet complex, rate and payment features that would catch the eyes of consumers and downplay the associated risks.[83] For example, the adjustable rates of subprime loans offer a borrower a low "teaser" rate which would convert into a floating rate after a period of time.[84]

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scope of this comment but represent two additional critical elements contributing to the global financial crisis. *See* Stefan Theil, *The Germans Are Toxic Too*, NEWSWEEK (Jun. 12, 2009), http://www.newsweek.com/2009/06/11/the-germans-are-toxic-too.html.

79. And by extension, a failure of American regulators.

80. The subprime mortgage market and its harmful effects have been classified by some as the result predatory lending. *See* Engel and McCoy, *supra* note 49, (for a discussion of the sub-prime mortgage market leading up to the crisis).

81. *See* Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RES. BANK OF ST. LOUIS REV. 31, 36-40 (Jan./Feb. 2006), *available at* http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf.

82. Chomsisengphet & Pennington-Cross, *supra* note 81, at 32. Such costs include: upfront costs including application fees, appraisal fees, and other fees associated with originating a mortgage, continuing costs including mortgage insurance payments, principle and interest payments, late fees and fines for delinquent payments, and fees levied by a locality. *Id.*

83. *See* Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 123, 134 (stating the two defining features of subprime mortgage contracts are cost deferral and complexity in terms).

84. Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-based Pricing*, 44 HARV. J. ON LEGIS. 123, 144 (2007); *see also* David Miles, THE UK

When approached with an offer to mortgage their property, borrowers were enticed by a lump-sum of money and the prospect of a low monthly rate.[85]

Efforts to make subprime mortgages more attractive were very successful as approximately half of those who were issued a subprime loan could have qualified for a lower interest loan.[86] The high proportion of people taking out less favorable and high-cost loans indicates the strong likelihood that consumers were not fully aware of the risky laden terms of the subprime loan.[87] A typical consumer had little to no chance of understanding or comparing the complex subprime products.[88] This apparent inability of consumers

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MORTGAGE MARKET: TAKING A LONGER-TERM VIEW, INTERIM REPORT: INFORMATION, INCENTIVES, AND PRICING §3 (2003) (concluding, based on an analysis of the UK mortgage market, that lenders can offer attractive teaser rates only because many consumers fail to refinance).

85. Among subprime loans, over half were for cash-out refinancing, while just over one-third were for a home purchase. Chomsisengphet, Souphala and Pennington-Cross, Anthony, *The Evolution of the Subprime Mortgage Market*, FED. RES. BANK OF ST. LOUIS REV., (Jan./Feb. 2006), 88(1). 41. In cashing in on their home's value, a great number of borrowers ignored the risks of increased leverage, fees, and changing interest rates. *See generally* Lee Anne Fennell, *Homeownership 2.0*, 102 NW. U. L. REV. 1047 (2008) (discussing effects of behavioral biases on real estate investments); Lauren E. Willis, *Decision making and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 754-84 (2006) (discussing behavioral biases afflicting mortgage borrowers).

86. *See* Oren Bar-Gill & Warren, *supra* note 13, at 38-39 (citing Lew Sichelman, *Community Group Claims CitiFinancial Still Predatory*, ORIGINATION NEWS, Jan. 2002, at 25) (reporting 40%) (citing James H. Carr & Lopa Kolluri, *PREDATORY LENDING: AN OVERVIEW, IN FINANCIAL SERVICES IN DISTRESSED COMMUNITIES: ISSUES AND ANSWERS* 31, 37 (Fannie Mae Found. ed., 2001) (reporting 35-50%) (citing Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit Worthy: As Housing Boomed, Industry Pushed Loans to a Broader Market*, WALL ST. J., Dec. 3, 2007, at A1 (reporting 55%)).

87. Oren Bar-Gill & Warren, *supra* note 13, at 39. *See also* Ren S. Essene & William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans*, 2, JOINT CTR. FOR HOUS. STUDIES, HARVARD UNIV. (2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf (showing borrower and loan specific factors can not explain the prevalence of subprime loans).

88. Oren Bar-Gill & Warren, *supra* note 13, at 39-40. *See also* Willis, *supra* note 77, at 726-27, (arguing that different mortgage products for borrowers in

to understand the fundamental information regarding a subprime loan occurred in an aggressive lending market environment fueled by the effects of securitization and the moral hazard it produced.

Securitization, discussed above, refers to the conversion of many home mortgages into securities backed by collateral in the form of pooled loans.[89] The process has dramatically changed the business of home finance allowing originators, or those who first make the loan, to sell the loan on the secondary market to financial institutions as a consistent source of capital.[90] Originators utilize brokers to market the mortgage product to borrowers, assess risk and arrange for financing.[91] Based on the size of the loan, brokers collect fees from both the originator and borrower.[92] This incentive structure was created by securitization, and it encouraged originators and brokers to expand the market for mortgages to include riskier borrowers.[93]

The persistent rise in the property market and low interest rates that characterized the years before the crisis fostered great demand for the mortgage backed securities.[94] By extension, this made the business of originators and brokers more profitable, which perversely translated into greater demand for subprime mortgage loans.[95] The

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similar financial situations create significant barriers to meaningful consumer participation in an efficient mortgage market).

89. *See* Tamar Frankel, SECURITIZATION: ASSET-BACKED SECURITIES AND STRUCTURED FINANCING, IN FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS 4-2 (Clifford E. Kirsch ed., 1999).

90. *See* Leland Brandsel, SECURITIZATIONS ROLE IN HOUSING FINANCE: THE SPECIAL CONTRIBUTION OF GOVERNMENT-SPONSORED ENTERPRISES, IN A PRIMER ON SECURITIZATION 24 (Leon T. Kendall & Michael J. Fishman eds., 1996) (explaining the function of originators has more simplified and competitive with the advent of securitization).

91. *See* DEPARTMENTS OF THE TREASURY AND HOUSING AND URBAN DEVELOPMENT, CURBING PREDATORY HOME MORTGAGE LENDING, at 37-40 (June 20, 2000).

92. *See id.* at 40; Cathy L. Mansfield, *The Road to Subprime 'HEL' was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 534 (2000).

93. Just ask yourself: In the past ten years how many phone calls have you received during dinner where you were asked to refinance your house?

94. *E.g.*, Gary Gorton, *The Subprime Panic*, YALE ICF WORKING PAPER, No. 08-25, 2 Sept. 30,2008, 5-6, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1276047.

95. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 137 (2007)

effects of this chain of demand recycled back into higher property values and increased demand for mortgage backed securities.[96] Securitization, combined with cheap credit and the robust housing property market, led brokers and originators to increasingly push subprime loans empowered by the market's mind-boggling perception of demand.[97]

The fervent market conditions exposed another consequence of securitization, the development of moral hazard. The concept of moral hazard refers to the dislocation of risk within a market, where a party has the power and incentive to take risks without being fully exposed thereto.[98] The principle assumes unknown risk because the transaction is carried out by an agent with conflicting incentives, the assessment of risk being removed from the model of rational decision making.[99]

In the market for subprime loans, brokers and originators had a financial incentive to sell as big a loan as possible. Through the process of selling that loan onto the secondary market, the sellers of the loan were able to escape, or insulate themselves from risk.[100]

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(showing that excess demand by investors for asset-backed securities led to additional subprime securitizations).

96. *See* Robert J. Shiller, *Understanding Recent Trends in House Prices and Home Ownership*, YALE ECON. DEP'T WORKING PAPER, No. 28, 2007), *available at* http:// papers.ssrn.com/sol3/papers.cfm?abstract_id=1017546 (explaining how housing prices increased from psychological feedback mechanism where increasing asset prices lured investors and drove a speculative bubble).

97. While fraudulent practices are outside the scope of this comment, it has been argued that these conditions created an environment ripe for predatory lending. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 137 (2007).

98. WEBSTER'S ONLINE DICTIONARY, *available at* http://www.websters-dictionary-online.org/definitions/Moral Hazard, (defining moral hazard as the lack of any incentive to guard against a risk when you are protected against it). The terms has its origins in the insurance industry occurring when the behavior of the insured party changes in a way that raises costs for the insurer, since the insured party no longer bears the full costs of that behavior. *See generally* Tom Baker, *On the Genealogy of Moral hazard*, 75 TEX. L. REV. 237 (1996).

99. David P. Baron & David Besanko, *The Rand Journal of Economics, Monitoring, Moral Hazard, Asymmetric Information, and Risk Sharing in Procurement Contracts*, 18-4, at 509-32 (Winter 1987.

100. Frederic S. Mishkin, Governor, *Leveraged Losses: Lessons from the Mortgage Meltdown*, Remarks at the U.S. Monetary Policy Forum, New York, N.Y. (Apr. 8, 2005), *available at* http://

Responding to a seemingly insatiable demand in the secondary market, brokers became increasingly aggressive in marketing the product while loosening underwriting standards.[101] Illustrating the effects of moral hazard, in the early 2000s stated income loans, once rarely used as a method to verify income, went into the mainstream.[102] This policy allowed mortgage brokers to make loans and qualify borrowers based on the unverified statements of borrowers regarding their income and assets.[103]

The factors discussed above compounded as they came together to create an perversely inflated market for subprime mortgages: a consumer credit product that was dangerous to consumers, prone to misunderstanding and executed with increasingly less underwriting standards. This massive market failure occurred not only at a time when credit was being made increasingly available, but when the traditional powers vested with the responsibility to regulate consumer financial products were eroding in the United States. This development will be discussed in the next Section, along with the legislation passed to stem it and the parallel debate in the United Kingdom.

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www.federalreserve.gov/newsevents/speech/mishkin20080229a.htm (discussing incentive problems created by "originate-to-distribute" model).

101. Not only did financial institutions profit from buy the mortgage backed securities, but were under the impression that the division, pooling and leveling of the loans insulated the securities from the risk of default. *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231 (2008) (describing risk spreading functions of the collateralized debt obligation, the type of securitization used in the subprime mortgage market).

102. Charles W. Murdock, *Why Not Tell the Truth?: Deceptive Practices and the Economic Meltdown*, 41 Loy. U. Chi. L.J. 801, 843 (2010). .*See also* Mark Zandi, *Financial Shock: A 360 Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis 17* (FT Press 2009) (2008) (reporting the nick name given to stated income loan with the mortgage industry: liar loans).

103. Murdock, *supra* note 102, at 843-44. Traditionally, such verifications methods were utilized to serve professionals and small business owners who lacked W-2 forms to verify income. *Id.*

## VI. DEREGULATION, DODD-FRANK, AND TURNING THE TIDE OF PREEMPTION

The following two Sections discuss the evolving regulatory structures, which are concerned with consumer financial protection with respect to rule-making authority at different governmental levels. In the United States, this involves a discussion of state versus federal power.[104] In the United Kingdom, this means a discussion of the United Kingdom's national power versus the super-national power of the European Union.[105] On both sides of the Atlantic, change has been initiated, in regimes already in influx, in the wake of the global financial crisis. As such, the prospect of a myriad of diverting regulatory propagation threatens to undermine the gains of the financial industry in creating harmonization among government financial regulations.

### *A. Deregulation Through Preemption in the United States*

A financial institution within the United States' dual banking system has the option of organizing itself under state or federal law, for example, becoming one of the fifty states chartered banks or a federally chartered bank.[106] Notwithstanding, individual states once

104. The Supremacy Clause of the United States Constitution, U.S. const. art. VI, cl. 2, permits a federal statute, to preempt state law.

105. The European Union is a novel political system created through a series of treaties among twenty-seven nations in Europe, pursuant to which various aspects of national sovereignty are ceded to the collective authority of the E.U., *see* http://europa.eu/abc/european_countries/eu_ members/index_en.htm for a list of the states the constitute the union. Three different government bodies execute authority of the member states: The Council of the European Union, consisting of the ministers from each of the member state; the European Parliament, directly elected by and representing the people of the various member states; and the European Commission, representing the common interests of the union. *See* Pascal Fontaine, Europe in 12 Lessons 17-20 (B-1049 Brussels 2006), *available at* http://ec.europa.eu/publications/booklets/eu_glance/60/en.pdf.

106. *See* Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting Off More Than They Can Chew?*, 56 AM. U. L. REV. 515, 515-16 (2007) (discussing the emergence of the dual banking system in the U.S); Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 3

had considerable power to regulate both federal and outside state banks through laws that protected consumers within their boarders.[107] This traditional authority has largely evaporated, however, and has been replaced by regulatory regimes that are mostly hollow of comparable regulations.[108] The destruction of state consumer financial protection laws, culminating in the mid-2000s, began in the late 1970s and was spearheaded by the United States Supreme Court.[109]

In 1978, the Supreme Court held that provisions of the National Bank Act[110] gave banks the ability to "export" their home-state's interest rate policy into states where they were conducting business.[111] The scope of this ruling was greatly expanded in subsequent cases to include a host of consumer financial protection provisions on interest rates and related fees.[112] The end result made

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(1977) (discussing the different ways a bank was traditionally able to organize itself).

107. *See* Elizabeth R. Schiltz, *The Amazing, Elastic, Ever Expanding Exportation Doctrine and its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 525-33 (2004); *see also* William Eskridge, *One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of the Home Sale and Loan Transaction*, 70 VA. L. REV. 1083 (1984) (discussing the history of state usury laws).

108. Oren Bar-Gill & Warren, *supra* note 13, at 79-83.

109. *Id. see also* CREDIT CARD PRACTICES: CURRENT CONSUMER AND REGULATORY ISSUES: HEARING BEFORE THE SUBCOMM. ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT OF THE H. COMM. ON FINANCIAL SERVS., 110th Cong. 70 (2007) (written testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School) (describing the effects of Supreme Court jurisprudence on state consumer financial protection law).

110. 12 U.S.C. § 85 (2006).

111. *See* Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 301 (1978) (affirming the Minnesota Supreme Court's holding that the National Bank Act "authorizes a national bank based in one state to charge its out-of-state credit-card customers an interest rate . . . allowed by its home state, even though that rate is greater than that permitted by the state of the bank's nonresident customers").

112. *See, e.g.*, Smiley v. Citibank N.A., 517 U.S. 735, 744-45 (1996) (extending the holding in *Marququtte* to include any payment compensating a creditor for an extension of credit, including numerical periodic rates, annual and cash-advance fees, bad-check fees, overlimit fees, and late-payment fees); *see also* Mark Furletti, *The Debate over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards*, 77 TEMPLE L. REV. 425, 426 (2004) (citing

states powerless to protect their consumers because banks were given the ability to base themselves in states with the most favorable regulations, for example in South Dakota, and regulations can then be exported to all other states where they do business.[113] These rulings, in effect, greatly limited the power of states to engage in consumer financial protection.[114]

Recently, more direct federal preemption has eliminated state laws on consumer financial protection in areas far beyond interest rates.[115] In 2004, the Office of Comptroller of the Currency issued a regulation that expanded the scope of federal preemption and insulated all banks under the auspices of its charter from any state laws that it determines will obstruct, impair, or condition a national bank's ability to fully exercise its federally authorized powers in four broadly-defined areas: real estate lending, lending not secured by real estate, deposit-taking, and other operations.[116] This broad expansion of federal authority, at the expense of state governments, has been upheld by the Supreme Court.[117] These developments have led many

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repeated rulings by various courts upholding federal regulators power to preempt state law under the National Bank Act).

113. Oren Bar-Gill & Warren, *supra* note 13, at 80, 81 n. 262 ("South Dakota enjoys tax revenues from banks that choose to locate in the state, while those banks enjoy profits generated by interest rates charged to customers in California and Massachusetts--profits that legislatures in California and Massachusetts specifically prohibit. Banks in haven states impose costs that are borne largely by consumers in other states.").

114. Oren Bar-Gill & Warren, *supra* note 13, at 79-83 (noting that state interest rate and fee regulation is not preempted by federal regulation, "[r]ather, the preemption follows from the federally defined rules applicable only to federally chartered banks. Specifically, the [National Bank Act] rule that interstate lending is subject to the laws of the state in which the lender is headquartered triggered interstate regulatory competition to attract lenders, and this competition effectively eliminated state-level price regulation").

115. *Id.* at 81-83.

116. *Id.* at 82-83 (citing 12 C.F.R. §§7.4008 (lending not secured by real estate), 7.4007 (deposit-taking), 7.4009 (other "operations"), 34.4(a) (real estate lending) (2008)).

117. *See* Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559, 1564-65 (2007). Further, even if the state law is not preempted, state enforcement is severely limited by the OCC's "visitorial powers" giving the OCC exclusive power to enforce both state and federal laws against national banks. *See* 12 C.F.R. § 7.4000; *see also* Clearing House Ass'n v. Cuomo, 510 F.3d 105, 120 (2d Cir. 2007) (validating the "visitorial powers").

to question if state consumer financial protection laws retain any relevance.[118] Also, indicating a more favorable federal regulatory environment is that over $1 trillion of banking assets have been transferred into the federal banking system from the states.[119]

Thus, the federal preemption of state consumer financial protection laws amounted to deregulation in two ways. First, competition among the states for tax-revenue led to the roll back of regulations in order to make respective state charters look more attractive to banks.[120] Second, there was direct preemption of state laws by an underdeveloped and unprepared federal regulatory regime.[121] It is within this regulatory environment, that the excesses of the subprime market were permitted, if not encouraged, to proceed unchecked.[122]

### *B. Dodd-Frank Attempts to Revive State Regulators*

The Dodd-Frank Wall Street Reform and Consumer Protect Act ("Dodd-Frank"), was signed into law by President Obama in July 2010 as a response to the global financial crisis.[123] Dodd-Frank, in

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118. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-387, 10-17, OCC PREEMPTION RULES: OCC SHOULD FURTHER CLARIFY THE APPLICABILITY OF STATE CONSUMER PROTECTION LAWS TO NATIONAL BANKS (2006), http://www.gao.gov/new.items/d06387.pdf (questioning the applicability of state consumer protection laws in light of OCC preemption power).

119. Oren Bar-Gill & Warren, *supra* note 13, at 82-83.

120. *Id.* at 83.

121. *Id. See also* Elizabeth R. Schiltz, *The Paradox of the Global and Local in the Financial Crisis of 2008: Applying the Lessons of Caritas in Veritate to the Regulation of Consumer Credit in the United Stated and European Union*, 26 J.L. & RELIGION 173, 183 (2010-2011) ("Although the federalization of consumer credit in the U.S. did entail substantive deregulation. . . . The deregulation occurred because the federal government did not act to regulate the entities over which it had gained exclusive jurisdiction.").

122. *See* Oren Bar-Gill & Warren, *supra* note 13, at 83 ("By permitting the states to compete for business by offering less and less consumer protection, the regulation scheme starts to unravel. Moreover, federal regulations that preempt state consumer protection without substituting other protection schemes create large holes in the regulatory fabric that encourage lenders to use a national charter to evade local protection. The combination not only leaves consumers with little protection, it also *creates structures in which the most aggressive lenders can pursue their tactics with impunity*.") (emphasis added).

123. *See* Pub. L. No. 111-203, 124 Stat. 1376 (2010).

creating the Bureau of Consumer Financial Protection ("BCFP") with a mandate to protect consumers in the financial service market, will add significantly to the federal regulation of consumer credit.[124] In addition to this provision,[125] Dodd-Frank curbs, in large part, the trend toward federalization of consumer financial protection through bolstering state control over regulation.[126] As such, financial institutions will be forced to cope with not just a new federal agency empowered to make right the global financial crisis, but also with fifty state governments empowered to reassert the lost regulatory prowess.[127]

State laws, generally, will be preempted *only* if they are inconsistent with federal consumer financial protection laws.[128] Moreover, a state law is *not* inconsistent if it provides greater

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124. Schiltz, *supra* note 121, at 182-83. The BCFP mandate is "to implement and . . . enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive." Dodd-Frank § 1021 (to be codified at 12 U.S.C. § 5511). The objectives of the BCFP will include ensuring that consumers receive "timely and understand information to make responsible decisions about financial transactions" and are protected from unfair deceptive, abusive and discriminatory practices. *Id.*

125. The BCFP is discussed in greater detail in the following section along with other provisions of Dodd-Frank related to consumer financial protection.

126. Michael Hamburger, *The Dodd-Frank Act and Federal Preemption of State Consumer Protection Law*, 128 BANKING L. J. 9 (2011), *see also* Schiltz, *supra* note 12, at 183 (stating "it is impossible to predict the exact nature of the balance between federal and state authority" [in the wake of Dodd-Frank]). For example, the bill rejects the Supreme Court's ruling extending preemption to non-bank subsidiaries of national banks. Dodd-Frank § 1046 (to be codified at 12 U.S.C. § 5565). *Contra* Waters v. Wachovia Bank, N.A., 550 U.S. 1, 20-21 (2007). Dodd-Frank also preserves for the states authority over usury limits. Dodd-Frank § 1027(o) (to be codified at 12 U.S.C. § 5517(o)).

127. As such, it should come as no surprise that Professor Elizabethan Warren, named by the President to head up the BCFP, stated in reference to Dodd-Frank: "A horde of lobbyist fought us every inch of the way . . . ." Elizabeth Warren, *Warren Outlines Goals for New Consumer Agency*, 29 AM. BANKR. INST. J. 10 (2011) (quoting Professor Elizabeth Warren, Remarks Delivered at the University of California (Oct. 28, 2010) (*available at* www.treas.gov/press/releases/tg932.htm)).

128. Dodd-Frank § 1041 (to be codified at 12 U.S.C. § 5551).

"protection provided under [Dodd-Frank]."[129] Further, a higher legal standard for federal preemption than was maintained by the OCC and validated by the Supreme Court is established, permitting preemption only if state laws are expressly preempted by federal law, would have a discriminatory effect on national banks, or would "prevents or significantly interferes with exercise of a national bank of its powers."[130] These provisions suggest that state regulatory regimes will no longer be replaced with a hollow a federal regime as discussed above. Moreover, states will have greater flexibility in promulgating regulations that should withstand federal preemption.[131]

On the other hand, these provisions of Dodd-Frank suggest an embrace of federal preemption to the extent that state regulations are weak.[132] In this way, the BCFP will be able to ameliorate the problem created by the National Bank Act and *Marquette* which undermined state regulation by allowing the importation of more favorable state regulation.[133] However, this preemption authority does not extend to provisions in other "enumerated consumer laws."[134] And although Dodd-Frank is silent on the matter, courts will likely be in the position to review and reverse the BCFP's

129. *Id.* The BCFP is authorized to determine whether a state law is inconsistent with Dodd-Frank on its own or in response to a petition by an interested person. *Id.*

130. Dodd-Frank § 1044(b)(1)(B) (to be codified at 12 U.S.C. § 25(b)). The quoted language is a direct reference to the Supreme Court decision in *Barnett Bank v. Nelson*, 517 U.S. 25 (1996). *See* 156 CONG. REC. S5902 (daily ed. July 15, 2010) (statements of Messrs. Dodd and Carper); *see also* Bruce, R. Christian, *Dodd-Frank Act's Language on Preemption Forces Some Quick Decisions, Lawyers Say*, 95 BNA'S BANKING REP. 168 (July 27, 2010) (arguing that by invoking *Barnett*, legislators intended to establish a more restrictive standard than the one the OCC asserted in previous regulations).

131. However, it widely believed that these provisions of Dodd-Frank will require significant judicial interpretation. *See* Schiltz, *supra* note 121, at 181-83.

132. Hamburger, *supra* note 126.

133. As such, South Dakota's favorable regulations may be preempted by regulation of the BCFP, limiting the regulatory race to the bottom encouraged by state competition for bank charters by proscribing a minimum.

134. Dodd-Frank § 1002 (to be codified as 12 U.S.C § 5481). "Enumerated consumer laws" include of example: the Consumer leasing Act of 1976, the Fair Credit Billing Act, the Home Owners Protection Act of 1998, the Fair Debt Collection Protect Act, Mortgage Licensing Act of 2008, the Truth in Lending Act, Truth in Savings Act and sections of the Gramm-Leach-Bliley Act. *Id.*

preemption determinations subject to the principles of judicial deference.[135]

States are further empowered through enforcement capabilities. Dodd-Frank explicitly gives states the power to enforce its provision and those to be promulgated by the BCFP.[136] Generally, a state attorneys general may bring a civil action in state or federal court to enforce the federal regulations and secure remedies provided for by federal law.[137] In addition, state regulatory agencies are empowered to initiate civil action or administrative proceedings to enforce Dodd-Frank and the BCFP's regulations.[138] Significantly qualifying this provision, state attorneys general are prohibited from enforcing *provisions* of Dodd-Frank against national banks, but may enforce a BCFP *regulation* provided a state court or federal district court in the state has jurisdiction over the entity.[139]

In order to ensure that these provisions are interpreted as limitations on state law, Dodd-Frank expressly states that none of its provisions limits or affects the authority of states to bring regulatory proceedings under state law.[140] Moreover, federal agencies are expressly limited from utilizing limitations on "visitorial powers" to curb state enforcement of regulations.[141] While somewhat tempered,

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135. *See* Nationsbank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 257 (1995) (citing Chevron U.S.A. Inc. v. Natural Resource Council, Inc., 467 U.S. 837 (1984) noting that if a statute is ambiguous on the topic, the charged agency's judgment is given "controlling weight") ). However, It is unclear if decisions concerning preemption would be given as much deference. *See* Hamburger, *supra* note 126, at n.35 (quoting *Watters*, 550 U.S. at 41) (Stevens, J. dissenting) ("[B]ecause administrative agency's are not designed to protect state's interest, 'when an agency purports to decide the scope of federal preemption, a healthy respect for state sovereignty call for something less than *Chevron* deference.'").

136. Dodd-Frank § 1042(a) (to be codified at 12 U.S.C. § 5552).

137. *Id.* The court must be one with the requisite jurisdiction over the defendant. *Id.*

138. *Id.* (requiring entity to be licensed, chartered, incorporated, or authorized to do business under the state's laws). *But see* Dodd-Frank § 1002 (to be codified as 12 U.S.C § 5481) (maintaining that this authority does not affect the provisions of other "enumerated consumer law").

139. Dodd-Frank § 1042(a) (to be codified at 12 U.S.C. § 5552).

140. Dodd-Frank § 1042(d) (to be codified at 12 U.S.C. § 5552).

141. Dodd-Frank § 1047 (to be codified at 12 U.S.C. § 25b). A provision of the National Bank Act exempted national bank from "visitorial powers" not

Dodd-Frank attempts to encourage official on the state level take an active role in enforcing federal regulations.[142] Working in conjunction with the newly established federal regulator, freshly empowered state governments create an environment where banks will face new rules and increased pressure of enforcement.[143]

## VII. REGULATORY HARMONIZATION IN THE EUROPEAN UNION

Mirroring, but to a lesser degree, the story of preemption in the United States is the move toward regulatory harmonization in European Union (E.U.).[144] The United Kingdom, along with other E.U. member states, has traditionally considered consumer financial protection as a subject of national, not supra-national, authority.[145] The desire for the free flow of commerce and a focus on regulatory harmonization to achieve that end, however, has brought the issue to

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authorized by federal law. 12 U.S.C. § 484(a). OCC interpreted the provision as limiting the use of "visitorial powers" to itself alone and defined "visitorial powers" as including: examination, inspection, regulation, supervision and enforcement with respect to national banks. 12 C.F.R. § 7.4000 (2009). Dodd-Frank codifies the Supreme Court's rejection of this interpretation. *See* Cuomo v. Clearing House Ass'n, 129 S.Ct. 2710, 2721-22 (2009) (holding that "visitorial powers" include only oversight and supervision, not enforcement).

142. Before a suit or proceeding is initiated, the BCFP and other federal regulators, with authority of the defendant, must receive notice along with a copy of the complaint from the state. Dodd-Frank § 1042(b) (to be codified at 12 U.S.C. § 5552). If such notice is not practical, notice must be given "immediately" upon commencement. *Id.* Once given notice, the BCFP may: intervene as a party, remove the action to federal court, and appeal any order or judgments as if it were party, regardless as to whether it chose to intervene. *Id.*

143. *But cf.* Hamburger, *supra* note *126*, at 9 (arguing that the impact of these changes to state authority is far from certain and will depend on the efforts of state officials; OCC attempts to preempted state law and the judicial decisions regarding preemption and deference).

144. A major difference in development within the U.S. and the E.U. concerning consumer credit product is regulation of the interest rate charges on loans, a power still firmly held by the individual member states. Schiltz, *supra* note 121, at 183.

145. *Id.* *See* generally ANTHONY S. HEAD, THE EUROPEAN UNION: A GUIDE FOR AMERICANS 5 (2009), http:// eurunion.org/eu/images/PDF/euguide2009.pdf (discussing the history of the European Unions and its origins).

the forefront of the E.U.'s agenda.[146] While facing considerable opposition, recent proposals stand to both buttress and limit consumer financial protection across the continent.[147] Nevertheless, member states, including the United Kingdom with its influential financial sector and regulators, are expressing timid support for limited increased harmonization.[148]

### *A. The Promise of Regulatory Harmony*

The European Union is premised on the principle of subsidiarity, which limits its actions, in areas not within its expressed authority, to policies where the objective is no better pursued at the local level.[149] Regarding consumer protection, the treaty organizing the E.U. provided that:

> In order to promote the interests of consumers and to ensure a high level of consumer protection, the Union shall contribute to protecting the health, safety and

146. *Consolidated Version of The Treaty on the Functioning of the European Union,* art. 114, Sept. 5, 2008, O. J. (C115) 94 (2008). (The E.U. "shall... adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market . . ."); Stephen Weatherill, EU CONSUMER LAW AND POLICY 1 (Edward Elgar 2005) ("Consumer protection . . . has a bearing on what is probably the most central issue of European economic integration, for it brings into very sharp relief the dialectics of open borders, protectionism, and bona fide interventions of the Member State to protect legitimate societal values and goals even if at the expense of interrupting the free flow of goods on which the idea of a common marketplace is postulated.").

147. *See, e.g.,* Jan M. Smits, *Full Harmonisation Of Consumer Law? Critique Of The Draft Directive On Consumer Rights* (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1358426 (last visited Mar. 20, 2010).

148. *See, e.g.,* HOUSE of COMMONS TREASURY COMMITTEE, *European Financial Services Regulation: Seventh Report of Session 2005-06,* H.C. 778, at 8 (2006). (reckoning "new regulation will have a clear benefit to the European economy"). However, U.K. policy makers also note that "[i]t is essential that European policymakers ask and receive answers to the simple questions that McCreevy is posing: Is there a case for action? Is it the EU that is best placed to act? Is a regulatory proposal the only possible solution?" *Id.*

149. Consolidated Version of The Treaty on the Functioning of the European Union, at art. 5(3).

> economic interests of consumers, as well as to promoting their right to information, education and to organi[ze] themselves in order to safeguard their interests.[150]

Taken together, these principles create a tension between a positive commitment to consumer regulations at a super-national level and a reluctance to remove national laws.[151] As such, the E.U. has relied on a theory of regulatory harmonization justifying consumer policies in the name of economic integration, its most fundamental principle.[152] The theory maintains that:

> [E]ven rules purporting to regulate exclusively intrastate trade may nevertheless operate to make the common market less 'common' and, to that extent, impede interstate commerce. . . . Even a subject plainly reserved as such to the States (e.g., health, education, or public safety) is transformed into a Community matter to whatever extent the federal political branches find that the cross-border mobility of goods (or, by parallel reasoning, workers, services, or capital) would be advanced by bringing the various national rules on the subject into closer alignment with each other. The theory, as one eminent expert pointed out, left 'no nucleus of sovereignty that the Member States could invoke, as such, against the Community.'[153]

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150. *Id.* at art. 169(1).

151. Weatherill, *supra* note 146, at 2.

152. *Id. See* Consolidated Version of The Treaty on the Functioning of the European Union, at art. 114, (The E.U. "shall... adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market . . . .")

153. George A. Bermann, *Taking Subsidiarity Seriously: Federalism in the European Community and the United States*, 94 COLUM. L. REV. 331, 355-357 (1994).

The history of E.U. directives on consumer credit highlight both tensions described above, and the theory of harmonization.[154] The first of these directives was in 1987, and while primarily concerned with disclosure, it required member states to conduct some supervision of lenders.[155] However, it explicitly provided that it "shall not preclude Member States from retaining or adopting more stringent provisions to protect consumers."[156] The directive was justified as promotion of market integration.[157] However, a series of studies have found that the directive did not result in any significant improvement in consumer financial protection or harmonization.[158]

### *B. Total Harmonization: Maximum Standards for Member States*

Responding to this initial failure and the increased focus on consumer financial protection brought by the crisis, the E.U. in 2008 proposed a new directive on consumer credit.[159] Written by the E.U. Commission, the first draft of the directive called for total harmonization, proscribing exclusive E.U. control of virtually all authority to substantively regulate consumer credit product.[160] Such attempts by the Commission to do for the E.U. what the Supreme Court did for the U.S. federal government, have been met with significant criticism from consumer groups who fear that total harmonization would undermine more protective legislation already in place in member states.[161] The latest version represents a

154. Schiltz, *supra* note 121, at 189-91.

155. *Id.* at 189 (citing Council Directive 87/102, 1986 O.J. (L 42) (EC)).

156. *Id.*

157. *Id.* issued before the Maastricht Treaty, which identifyied consumer protection as an issue over which the E.U. had authority, "[t]he Directive operates on the 'assumption . . . that the consumer will benefit from the process of integration through the enjoyment of a more efficient market, which will yield more competition allowing wider choice, lower prices and higher-quality products and services.'" *Id.* at 190 (quoting Weatherill, *supra* note 151).

158. Schiltz, *supra* note 121, at 189-90 (citing Hans-W. Micklitz, Norbert Reich, Peter Rott, UNDERSTANDING EU CONSUMER LAW 38-34 (2009)).

159. Council Directive 2008/48, 2008 O.J. (L 133) (EC).

160. Schiltz, *supra* note 121, at 189-90 ("The draft also imposed significant substantive regulation, including affirmative obligations on the part of lenders to abide by a principle of 'responsible lending.'").

161. *See, e.g.*, Nikki Tait, '*Consumer Rights Bill Proposals Cause Anger*, FINANCIAL TIMES, Dec. 20, 2010.

compromise, claiming for the E.U. exclusive authority over all matters directly addressed, but mostly limits these regulations to disclosure requirements.[162] Article 22(1) states that"[i]nsofar as this Directive contains harmonized provisions, Member States may not maintain or introduce, in their national law provisions diverging from those laid down in this Directive."[163] Mirroring similar provisions in Dodd-Frank, with respect to matters not directly addressed in the 2008 E.U. directive, member states retain the authority to regulate.[164]

The renewed emphasis on harmonization is still being debated in the context of a proposal addressing a number of policy initiatives concerning consumer financial protection, which was first introduced in 2008.[165] One provision in this proposal, which stands in stark contrast to the comparable Dodd-Frank legislation, is the restriction on member state regulations that are *more* stringent than those

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162. Directive 2008/48/EC, O.J. (L 207) 2 (EC) Preamble P (9). The Directive explains:

> Member States may, for instance, maintain or introduce national provisions on joint and several liability of the seller or the service provider and the creditor. Another example of this possibility for Member States could be the maintenance or introduction of national provisions on the cancellation of a contract for the sale of goods or supply of services if the consumer exercises his right of withdrawal from the credit agreement. In this respect Member States, in the case of open-end credit agreements, should be allowed to fix a minimum period needing to elapse between the time when the creditor asks for reimbursement and the day on which the credit has to be reimbursed. *Id.*

163. *Id.*

164. *See Proposal for a Directive of the European Parliament and of the Council on Consumer Rights*, Comm.n of the European Cmtys. (Aug. 10, 2008), http://ec.europa.eu/consumers/rights/docs/directive_final_EN.pdf.

165. *See supra* note 163. The current directives provide for minimum harmonization because member states are left free to maintain or adopt stricter national rules than those adopted in the respective directives; the proposals however, would adopt the same full harmonization as in the 2008 Directive, forbidding member states from maintaining or adopting provisions diverging from those in the proposal. *Id.*; *see also,* Nikki Tait, *EU Moves on 'Unfair' Bank Charges*, FINANCIAL TIMES, Jan. 20, 2011.

promulgated by the E.U.[166] It has been argued that a standardized set of regulations that maintain maximum and minimum threshold limitations on consumer financial protection benefits the economy and ultimately provides consumers with greater protection.[167] This curious logic, which forbids stricter regulations on consumer financial product for the sake of consumer protection, forms the basis for criticism of total harmonization that has only increased with the advent of the global financial crisis.[168]

## VIII. DOUBLING DOWN ON CONSUMER FINANCIAL PROTECTION IN THE UNITED KINGDOM

Recent developments in the United Kingdom suggest that policy makers there are not too worried about E.U. directives taking away their nation's initiative to regulate consumer financial protection. On the contrary, the global financial crisis has only led government

166. *See supra* note 163. ("Member States may not maintain or introduce, in their national law, provisions diverging from those laid down in this Directive, including more or less stringent provisions to ensure a different level of consumer protection.") *with* Dodd-Frank § 1041 (to be codified at 12 U.S.C. § 5551) (describing a state law as *not* inconsistent, and permissible not inconsistent, if it provides greater "protection provided under [Dodd-Frank].").

167. Colette Cuijpers & Bert-Jaap Koops, EURO. L. REV. 2008, 33(6), 880-897, 896, How Fragmentantion in European Law Undermines Consumer Protection: The Case of Location-Based Services. (arguing that "fragmentation erodes both pillars of European law-making in the area of consumer protection: neither harmonization nor a high level of protection is achieved. The legal uncertainty caused by fragmented rules both constitutes a disincentive to promising new technologies and services within the internal market and undermines an adequate level of consumer protection throughout the European Union"). *But see*: Commission Staff Working Document – European Financial Integration Report, Comm'n of the European Cmtys. 37 §2(1) (Oct. 12, 2007), *available at* http://ec.europa.eu/internal_market/finances/docs/cross-sector/fin-integration/efir_report_2007_en.pdf (warning that a harmonized regulatory regime and "market links do not only contribute to risk diversification but may also serve as channels for cross-border contagion, transmitting risks across the financial system").

168. Iain Martin, *FSA Warns Europe: Don't Impose Blanket Rules on Financial Services*, CITYWIRE, (Jan 27, 2011), http://citywire.co.uk/new-model-adviser/fsa-warns-europe-dont-impose-blanket-rules-on-financial-services/a466729 ("We do not think that consumers are well-served if there is maximum harmonizing legislation that in some way equates the mortgage market in Slovenia to the Dutch market to our own.").

officials to rethink financial regulation and place a greater emphasis on regulating consumer credit products. Regulators in the United Kingdom have warned the E.U. Commission considering more expansive supra-national regulations by stating that the "most effective way [regulators] can protect consumers is to tailor regulation in a way that combats the specific market failures which they face."[169] This Section discusses the reforms being pursued in the United Kingdom that will, independently of the E.U., add to the growing financial regulatory structure.

### *A. The Fall of the Financial Service Authority*

"At the heart of the crisis was a rapid and unsustainable increase in debt that our macroeconomic and regulatory system utterly failed to identify let alone prevent," stated the United Kingdom's new Chancellor of the Exchequer, George Osborne, when he announced abolishment of the Financial Services Authority ("FSA").[170] The FSA has been the dominant financial regulator in the United Kingdom for more than a decade.[171] In 1997, then Chancellor of the Exchequer Gordon Brown transferred bank and financial service regulation from the Bank of England to the FSA.[172] Along with the Treasury, the three regulators formed a tripartite system intended to facilitate discussion of issues, the exchange of information, and the coordination of responses to any problems in the sector.[173] In the

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169. *Id.*

170. Gonzalo Vina, *U.K. Scraps FSA, Reversing System Set Up by Brown*, BUISNESSWEEK, (June 17, 2010), *available at* http://www.businessweek.com/news/2010-06-17/u-k-scraps-fsa-reversing-system-set-up-by-brown-update2-.html. ("He's blamed the system established by former Labour Prime Minister Brown for failing to prevent a financial crisis that saddled taxpayers with liabilities of as much as 1.4 trillion pounds ($2.1 trillion) and plunged the economy into the worst recession since World War II.").

171. *See* G. WALKER AND M. BLAIR, FINANCIAL SERVICES LAW 1 (Oxford: Oxford University Press, 2006). *See also* D. SINGH, BANKING REGULATION OF UK AND US FINANCIAL MARKETS (Aldershot: Ashgate Publishing, 2007) (comparing U.S. and U.K. regulators).

172. Philip Rawlings, *Reform of Bank Regulation in the United Kingdom: the Opening Salvo*, J. INT'L BANKING L. REG. 2010, 2010, 25(10), 522-528.

173. Luis Garicano & Rosa M. Lastra, *Towards a New Architecture for Financial Stability: Seven Principles*, J. INT'L ECON. L.,13(3), 597-621, 601-02 (2010). Spelled out in a Memorandum of Understanding in 1997, the Bank of

initial response to the crisis, the Government, led by Prime Minister Gordon Brown, further bolstered the FSA's authority.[174] His government was ousted from power in May, 2010, replaced by a coalition government dedicated to ending the FSA's hegemony.[175]

The new government, led by the Conservative party, has long opposed the FSA and the tripartite system of regulation, claiming it is ineffective at monitoring risks.[176] The Conservative's Chancellor of the Exchequer, George Osborne, announced a radical redrafting of financial regulation on June 16, 2010, which was followed by the publication of a consultation document on July 26, 2010.[177] The reform is rooted in a belief that the existing regulatory structure meant that no one had sufficient responsibility for critical issues, and thus, no regulator was in a position to recognize the coming of the crisis and prevent or react to it.[178] The Bank of England will regain much of its regulatory authority and will sit at the center of the new

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England acts palender of last resort, the FSA is the supervisor and the Treasury is responsible for the fiscal costs of bail-outs. *See* The Turner Review: A Regulatory Response to the Global Banking Crisis, Fin. Servs. Auth. (March 2009), *available at*http://www.fsa.gov.uk/pages/library/corporate/turner/index.shtml.

174. *See* The Financial Service and Markets Act of 2010.

175. *The Coalition: Our Programme for Government*, (May 20, 2010), *available at* http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf. "We therefore find ourselves in this uncomfortable interim period, during which very significant changes to the regulatory system are being implemented, yet in the knowledge that the regime as a whole is soon to be dismantled by the new government and rebuilt from scratch." Nathan Willmott; Peter McGowan; Mark Ghusn; Victoria Brocklehurst; Rachel Aikens; Sarah Bailey; Mark Scodi; James Palme; Ruth Whorto; and Alexander Gold, Equipping the modern regulator: assessing the new regulatory powers,(can't find this anywhere thus send back to author) COMPLIANCE OFFICER BULLETIN, 78(Jul/Aug), 1-28, 2 (2010). However, the coalition government stated on June 17, 2010, that the Consumer Protection and Markets Authority will continue to have an important role in the new regulatory architecture. *See id.* at 18.

176. Economy, Conservatives, http://www.conservatives.com/policy/where_we_stand/economy.aspx. *See also* The Coalition, *supra* note 175.

177. A New Approach to Financial Regulation: Judgment, Focus and Stability CM 7874, HM Treasury (July 2010), http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf.

178. *Id.* The Bank focused on monetary policy rather than financial stability, and the FSA concentrated on the supervision of individual institutions and paid insufficient attention to wider risks. *Id.*

regulatory regime.[179] The remainder of the FSA will essentially be replaced by three new agencies: Prudential Regulatory Authority, which is part of the Bank of England; the Economic Crime Agency; and the Consumer Protection and Markets Authority ("CPMA").[180]

### *B. The Financial Conduct Authority*

On February 16, 2011, United Kingdom government authorities announced that the CPMA will be renamed the Financial Conduct Authority ("FCA"), "[i]n order to reflect more directly its role."[181] The FCA, a "separate and focused *conduct regulator* with tailored objectives, functions and powers," parallels the BCFP established in the United States under Dodd-Frank.[182] The agency found support in a very influential report commissioned by the treasury that linked consumer financial protect to the crisis.[183] The FCA will act as a "consumer champion."[184] However, it "should not be confused with

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179. George Osborne, "Speech at the Lord Mayor's dinner". Also, Hansard, HC, col.1056 (June 17, 2010) ("Our thinking is informed by this insight: only independent central banks have the broad macroeconomic understanding, the authority and the knowledge required to make the kind of macro-prudential judgments that are required now and in the future.").

180. A New Approach to Financial Regulations: Judgment, Focus and Stability, *supra* note 177.This supervisory and regulatory overhaul is expected to be completed in 2012. *Id.*

181. HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: BUILDING A STRONGER SYSTEM, CM 8012, 59-60, (Feb. 2010) ("[T]he FCA will have, as its core purpose, protecting and enhancing the confidence of all consumers of financial services . . . ."). *Id.* at 60.

182. *See id.* at 59 (emphasis added). In the words of Chancellor of the Exchequer Osborne: "We will also establish a powerful new Consumer Protection and Markets Authority. It will regulate the conduct of every authorized financial firm providing services to consumers. It will also be responsible for ensuring the good conduct of business in the UK's retail and wholesale financial services, in order to preserve our reputation for transparency and efficiency as well as our position as one of the world's leading global financial centres." Speech by Osborne, *supra* note 178.

183. A New Approach to Financial Regulation: Building a Stronger System, *supra* note 180.

184. *Id.* FCA will also operate to meet a statutory objective to promote market efficiency. *Id.*

that of consumer advocate organi[za]tions.[185]

The FCA's strategic objective will be to ensure consumer confidence in the financial service sector.[186] The FCA's operational objectives are: "facilitating efficiency and choice in the market for financial services; *securing an appropriate degree of protection for consumers*; and protecting and enhancing the integrity of the UK financial system."[187] The FCA will have rule-making functions and will be the sole regulator for "a significant majority" of financial institutions in the United Kingdom.[188] Although independent, the Consumer Financial Education Body will be under the auspices of the FCA and will be charged with raising the public's knowledge and understanding of financial matters and will enhance their ability to manage their own affairs.[189]

It has been argued that "the creation of the [FCA] should improve efficiency by bringing together consumer protection and conduct of business issues spread between the FSA" and other regulators.[190] Nevertheless, the regulatory state of affairs in the United Kingdom is far from certain, even when compared to the United States and the E.U.; and in any event, a financial institution can expect to find a new regulator regime in the United Kingdom empowered to aggressively pursue expanding objectives.[191]

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185. *Id.* ("The FCA will be an entirely impartial regulator from whom firms and consumers can expect fair treatment.").

186. *Id.* at 61. (Feb. 2010) ("Conduct of business regulation has a fundamental role to play in protecting and enhancing that confidence in the UK financial system.").

187. *Id.* at 62. Further, "[t]he FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition." *Id.*

188. *Id.* at 69.

189. *Id.* at 102.

190. Philip Rawlings, *Reform of Bank Regulation in the United Kingdom: The Opening Salvo*, J. journal volume # INT'L BANKING L. REG. 25(10), 522-28, 526 (2010).

191. Compliance Officer Bulletin states that professionals face:

> [A] prolonged period of radical change to UK financial services regulation. As firms adapt to and seek to understand the new powers recently bestowed upon the FSA, they are also beginning their preparations for life under a new regime. What is clear is that the risk and compliance burden on firms will

## IX. CONCLUSION – UNCERTAINTY FROM DEREGULATION

This Comment highlighted the critical changes occurring in the structure of financial regulation around the world. The environment is far from settled and will likely remain so for the foreseeable future.[192] Lasting uncertainty is just one of many challenges financial institutions will be forced to grapple with in the coming years. The roots of these challenges can be found in the conclusion held by policy makers that regulators failed to protect consumers from a failed market for consumer credit, and that this failure of government led to an economic collapse. In Europe and in the United States, this conclusion has led to the creation and revitalization of regulators with new authorities. Moreover, these new regulators are empowered by the persisting realities and memories of the global financial crisis along with the painful recession that came in its wake.

Much of the substantive regulation that will come from Washington, London, and Brussels will be unwise and not aimed at addressing the causes of the financial crisis. Leaders will, of course, use the concept of the crisis to implement plans conjured up long before the collapse of the American housing market. Nevertheless, as this comment shows, the responses to the global financial crisis have led to significant reversals in regulatory trends towards deregulation. Preemption in the United States led to de facto deregulation. The mess this caused, however, is now being used to justify a regulatory regime that stands the possibility of being more hostile to lenders than any in the past. Before advocating for further harmonization in Europe, financial institutions may want to reflect on

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> continue to grow as they gear up for dealing with multiple regulators who will wield an expanding selection of supervisory and enforcement tools, and who can be expected to use those tools aggressively to pursue their potentially inconsistent regulatory objectives. *Id.*

192. *See, e.g.*, Jessica Holzer, *Financial Regulator Appoints Top Team*, WALL ST. J., Feb. 18, 2011, (discussing the build-up of the BCFP in Washington, D.C.); Simon Clark & Ben Moshinsky, *'Arrogant' London Bankers Learn to Lobby Brussels as Power Moves*, BLOOMBERG, Feb. 14, 2011, ("London, the financial capital of Europe, is coming to grips with a foreign concept: None of its three most important regulators speaks with a British accent.").

how deregulation has left them more tied down than ever.