

Proposal for a Financial Product Approval Process with Modified File-And-Use Elements, Public Scrutiny, and Committed Experimentation

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Summary:

At the center of current debates over the financial crisis and the “Great Recession” is the idea that the introduction and marketing of retail financial products ought to be regulated more comprehensively. Various proposals have been offered to this end, based upon different models, such as a safety commission, an FDA for finance, state insurance regulations, or forms of self- or professional regulation. In this memorandum, I propose a flexible regulatory regime that incorporates a mixture of these ideas, combining elements of multiple proposals and offering some more specificity. The regulatory body described in this document holds the promise of both increasing consumer safety and improving the ability of market mechanisms to create information, and to stimulate more efficient and useful innovation.

Proposal Outline:

- (1) Adopt elements of a **file-and-use system** (as used in state insurance regulation): Any originator of a new safety-regulated retail financial product [SRRFP, or “surf-up”] (e.g., mortgages, credit cards, pay-day loans, etc.) would file a “notice to introduce a safety-regulated retail financial product” to a newly established Commission. The notice would contain a marketing plan, and a schedule for data collection and experiments with the SRRFP. The Commission would have six months (180 days) to review the notice and, upon its determination, could halt the introduction of the product at any time during this interval. If by the expiry of the 180-day limit the Commissioner had not acted, the originator would be free to market the product.
- (2) Require **pre-commitment to experimentation**: In the notice to introduce, the loan or mortgage originator (the product supplier) would commit explicitly to a schedule of experiments and observational data collection that would reveal how various groups use the product, and risks associated with each. These schedules, and the experiments and data composing them, would be subject to regulatory approval along with the product itself.
- (3) Create a system for **public scrutiny of the product**, both by regulatory experts and an appointed advisory committee, and by disclosure of many (but not all) of the instrument’s particulars to the public, so that various stakeholders could weigh in with their affirmation or their concerns. The idea here is that if the instrument does not pass the scrutiny of public and expert intuition, its chances of approval should be diminished.

(4) Establish a **Financial Product Safety Commission (FPSC) headed by a single commissioner** appointed by the President, to implement this process. Ensure that the FPSC has sufficient resources and administrative capacity (including rulemaking and analytic capacity, data-gathering capacity, and capacity to issue sufficiently deterring fines and referral of criminal violations to the Department of Justice) to effectively protect consumer financial safety in the United States.

(5) Institute an **advisory council reporting directly to the Commissioner** to advise the FPSC, with representation from across academic disciplines and the spectrum of public interests (including but not limited to psychologists and sociologists, legal scholars, historians and political scientists, and academic economists and finance scholars, representatives of the small business community, mortgage lenders, credit card companies, labor, etc.). Broad representation from multiple disciplines in the academic world and from multiple groups and perspectives in the public, and public access to deliberations, is essential in order to militate against capture by business interests or capture by academics. The advisory council would hold at least one set of hearings prior to the approval or rejection of each financial product.

(6) **Making Markets Work Better: The Flexibility and Incremental Benefits of the Proposed System.** The core idea here is to harness the power of information to improve regulation, product safety, Americans' financial literacy, and the retail finance market itself. A file-and-use process for safety-regulated financial products, with committed experimentation and data collection, and overseen by a Commission, would standardize collection and distribution of data that industry already gathers. The key value-added is that (1) consumers and the public would now be armed with much of the same information, and (2) the information could be collected more comprehensively and scientifically than before. Without a file-and-use process, however, the incentives to produce and distribute this information for maximum benefit to all will be lost.

Introduction: Regulating financial products to promote safety and market efficiency.

The idea of safety is one widely observed in advanced, democratic societies: when citizens consume complex products, they are never fully aware of the risks that confront them and “markets for information” work poorly to convey the necessary data to them. In fact, in many advanced economies, markets provide incentives for producers to provide limited or distorted information to the customer. With asymmetric information between producers and consumers, a state of “equilibrium fraud” will develop unless a government regulator structures the market to make it work better.

This confidence-producing and market-making function is the single most important legacy of safety regulation in food and drugs, and it is one of the main reasons that so many other nations

have tried so diligently to copy our arrangements closely in their governance of food and drug markets. While we are all aware that the market for prescription drugs has many problems, the American citizens' confidence in and knowledge of the safety risks of a prescription drug are far greater than their confidence and knowledge of the safety risks of financial products. Accordingly, we should adopt a similar safety regime to regulate certain financial products.

I propose that financial product safety legislation needs to begin not with the idea of an agency which oversees particular companies, but rather with the idea of a regulated product and an application or file-and-use process of product entry. Legislation should create a new legal category, that of a **safety-regulated retail financial product** [SRRFP, or "surf-up"], with residential mortgages, credit cards, and pay-day loans, as obvious examples.

The Commission would define the range of financial products to be regulated, subject to broad parameters of scope laid out in the enabling statute. The core of this idea is to define what is meant by a regulated financial product. It is not clear that all products should fall into the same regulatory category.¹ Perhaps payday loans, credit cards, and certain personal/family mortgages should be subject to safety regulation; perhaps savings accounts, money transfers and bridge loans should be subject to less regulation. This boundary is one for Congress and the President to consider jointly.²

¹ As a reference point, consider that in prescription pharmaceuticals there are a range of products considered safe enough to be "self-administered" by the citizen/patient and hence bought and sold "over-the-counter." [Thanks to David Moss for this insightful analogy.] The key here is that (1) regulation in this area establishes a distinction between products that really need regulation and products that don't need it (or need less of it), and (2) this distinction (and its boundary between more- and less-regulated products) is a regulatory decision subject to transparency and the rule of law.

² In order to minimize undesirable conflicts of jurisdiction – such as a wish that the SEC retain its current jurisdiction, for example, or a desire to avoid conflicts with state insurance regulation – a safety-regulated retail financial product could be defined in ways that preserve the jurisdiction of existing regulatory arrangements, or the enabling statute could explicitly delegate authority over certain sub-categories to other agencies. We should not, however, forget the benefits of redundancy and some jurisdictional competition, even in the government realm where we usually demand clear lines of authority. See Jonathan Bendor, *Parallel Systems*, (Berkeley: University of California Press, 1986). C. F. Larry Heimann, *Acceptable Risks* (Ann Arbor: University of Michigan Press 1995); Michael Ting, "A Strategic Theory of Bureaucratic Redundancy," *American Journal of Political Science* (2002); Daniel Carpenter, *The Forging of Bureaucratic Autonomy: Networks, Reputations and Policy Innovation in Executive Agencies, 1862-1928* (Princeton: Princeton University Press, 2001).

Proposal: A Modified File-and-Use System with Elements of Prior Approval and with Post-Marketing Reports and Data Collection

(1) Adopt elements of a file-and-use system.

After establishing products and not companies as the basis of safety regulation – following TARP Congressional Oversight Panel chair and Harvard Law School professor Elizabeth Warren’s suggestion – new regulatory legislation could establish a predictable and low-administrative-cost process for regulatory approval of new financial products. Originators of new financial products would file a **“notice to introduce a safety-regulated financial product”** to the newly established FPSC. The notice would contain a description of the product, details of the companies’ marketing plan (with appropriate exceptions for proprietary information that would preserve incentives to innovate³) and a schedule for post-market data collection and ‘roll-out’ experiments with the SRRFP. The Commission would have six months (180 days) to review the notice and, upon its determination, could halt the introduction of the product at any time during this interval. The Commission could also defer a decision by refusing to grant immediate approval to the originator firm and by requesting a re-filing. If by the expiry of the 180-day limit the Commissioner had not acted, the originator would be free to market the product.

(2) Require pre-commitment to data collection and experimentation.

In the notice to introduce a SRRFP, the loan or mortgage originator (the product supplier) would commit explicitly and legally to a schedule of observational data collection and experiments (SDCE) that would reveal the risks, the benefits and the heterogeneity of use in the product. This schedule and the experiments composing it would be subject to regulatory approval along with the product itself. If the Commission and the Commission’s advisory council did not approve of the schedule of data collection and experiments (SDCE), then the Commission would defer approval of

³ Again, this is exactly the kind of protection that is routinely given to insurance companies by state insurance regulators, as well as to pharmaceutical companies in the new drug application process of the FDA. So it is not difficult to design a process where there is public disclosure of the essentials of a new product while retaining broad protection for trade secrets and other proprietary information.

the notice product and notify the originator of the necessity of a resubmission under the modified file-and-use procedure.⁴

The notions of “data” and “experiment” here should be broadly conceived. A three- or four-phase system of “clinical trials” will not work for financial products; we need a system of experimental and non-experimental (including historical) data collection that is appreciative of the peculiarities of the retail financial market. Here is what a schedule of financial experiments and data could include:

- **Simulations** of the performance of financial products and markets, including (critically) behaviorally realistic simulations that include (a) consumers with limited information, biases and limited education levels and (b) marketers with superior information and incentives to manipulate consumers.⁵ [As a metaphor only, consider the idea that such simulations would be of the “war game” variety, drawing upon important advances in “agent-based modeling” and computational stochastic models. Many of these methods are already commonly used by financial analysts in various branches of private industry to value their own assets and liabilities.]
- **Laboratory experiments** by psychologists and experts in behavioral finance. Imagine that an array of three or four financial products (mortgage products) was presented to a hypothetical citizen or couple or family. Judging from afar, it might be immediately obvious that for some people, the new financial product (for instance an adjustable-rate mortgage with two-year ‘teaser’ rate) does not make good sense, given the availability of another financial product that is identically beneficial but carries much less risk and is clearer. In the laboratory setting, have an aggressive marketer or salesperson try to sell this less safe product to the subject. Conduct such an experiment on 25-100 subjects. Then ask the following questions. How often would consumers and citizens make the wrong decision under an aggressive marketing plan? What sorts of consumers (relative age, education, financial circumstances) would make the wrong decisions more commonly? What sorts of marketing

⁴ Under a more rigorous system of financial products safety regulation, the Commission might require completion of some of this data collection and some experimentation before granting final marketing approval or the product, or (equivalently) might require that some of this data be included and revealed to the Commission in the original notice of filing of a SRRFP.

⁵ Even if well-principled lenders do not behave this way eventually, it is critical to imagine and simulate worlds in which they did.

plans would lead to more consumer error, and which plans would lead to less consumer error? What plans would lead to healthy and appropriate profit for the lenders and which would not? [These questions could also be asked and addressed with appropriate simulation designs.]

- **Collection and analysis of data from similar financial products in other markets.**

Perhaps the new financial product that is sought in the United States has already been introduced in another country, or in another form of marketplace (insurance) or at another time in the past. A company should be required to “do its homework” before introducing a new product (so should the regulatory agency before giving the green light); examining the history of similar products in the past is one way of doing this “homework.”

- **Observation (including ethnographic) of citizens’ and consumers’ experiences with the product.** There is some knowledge that simply cannot be quantified, and even where it can be quantified, intuitive and systematic human observation can tell us much that statistical analysis cannot. Appointing trained observers to systematically follow the experience of a select small sample (10-50) citizens and consumers as they interact with these new financial products would be an absolutely necessary complement to quantitative data analysis. This knowledge would also allow for the tracing of consumer decisions and, if used appropriately, would benefit all of society including the firm attempting to sell the product and the consumers. It is critical that in such studies, citizen and consumer privacy be protected; again, such studies are common in the academic and consumer worlds and strong privacy protections have already been developed for those realms.

Develop a financial product safety label, following data collection and experimentation.

A critical component of most products is that summary information about them is distilled into an understandable form and is presented in a single place (think of the MSRP sheet at an auto dealer, or a drug label, or nutritional label on a food product). Unfortunately, for most retail financial products the labels either do not exist or the accompanying information is of such complexity (and burdened down with so much fine print) that the essential information is concealed. What experts know about new financial products already should be clearly presented to their current and future consumers. The data collected under a modified file-and-use system of financial product innovation should also be presented to consumers. What if citizens and consumers in North Carolina knew, when purchasing a new mortgage, that 10 percent of people in their income range had defaulted on this

same mortgage in the state of Georgia in the past five years? What if American citizens and consumers knew that for the product they were considering, 20 percent of the people who were aggressively sold the product in a fair and independent experiment were duped and eventually regretted their decision, and would have chosen something else if they had all the information? More importantly, *what if retail financial marketers were required (like drug companies and food companies) to present these risks to American citizens when selling these products to them?*

Two crucial points:

First, **companies already collect this data** (all forms of the data mentioned above). So there is nothing about this proposal that entertains any radical intrusion into citizens' or consumers' lives. What is different is that, *in this proposal, companies and lenders are not the only parts of American society armed with this information*. Parts of this data can be selectively disclosed (not unlike the manner in which summary statistics about drugs and their effects are revealed in a good drug label), hence creating a better-informed public at the same time that proprietary information and firm incentives to collect and use information can be preserved and even enhanced.

Second, an important principle that must be observed by any regulatory reform is the **principle of heterogeneity**. For some people, for example, payday lending may be highly beneficial, providing access to liquidity that is sorely needed to make ends meet and to plan for future savings and investment decisions. For other people, it may be disastrous and full of opportunities for manipulation and misrepresentation. A critical feature of any data collection by a regulator must be the collection of data that speaks not just to average risks (the average default probability, for instance) but how different Americans interact differently with the product. Again, this information is not just important for financial product safety; it will help all of us make better financial decisions.

(3) Create a system for public scrutiny of the instrument.

Finally, it is critical to understand the value of **pre-marketing scrutiny of the instrument**. This is a feature of state insurance regulation and product safety regulation worldwide at the present time. We need not establish a full FDA-like process of clinical trials to have educated and

intuitively-driven, impartial experts and observers conduct initial screenings, or a “smell test,” on new financial products. In my proposal, such scrutiny would be conducted both by regulatory experts (the Commissioner and her/his staff) and the Commission’s appointed advisory committee [certain proprietary information would be disclosed, under stiff federal penalties of revelation, to the Commissioner and selected staff, just as is done at the FDA now]. In addition, in this proposal there would be disclosure of many (but not all) of the instrument’s particulars to the public (online), where various stakeholders could weigh in with their affirmation of the product or their concerns; the idea here is that if the instrument does not pass the scrutiny of public and expert intuition, its chances of approval should be diminished.

(4) Establish a Financial Product Safety Commission headed by a single Commissioner.

This legislation would create a Financial Product Safety Commission (FPSC), headed by a single commissioner appointed by the President. I think a single commissioner (the FDA model or the EPA model) is superior to a voting commission, along as there are appropriate advisory committees and public disclosure requirements that militate against too much secrecy and capture. A voting commission ends up concentrating the capacity of the organization at the top level, where each individual commissioner ends up using Commission expertise like a legislator uses a staffer. A single Commissioner would be able to centrally organize expertise and delegate important decisions down the administrative hierarchy. Staff would be accountable to a single authority and, ultimately, to the people. The existence of an advisory committee would ensure that important issues were publicly deliberated and that informative votes were taken on issues of significant public and financial salience.

(5) Institute an advisory council reporting directly to the Commissioner.

Scholars and observers of regulatory agencies often worry about capture.⁶ In the Progressive Era and in the 1960s, it was commonly thought that advisory committees would stand as a bulwark to capture. Advisory committees have many advantages, but in order for them to work well they need (a) broad representation from numerous perspectives⁷ and (b) public disclosure and transparency. I would propose a single advisory council, reporting directly to the Commissioner of Financial Product Safety, with representation from across academic disciplines and the spectrum of public interests (including but not limited to psychologists and sociologists, legal scholars, historians and political scientists, and academic economists and finance scholars, representatives of the small business community, mortgage lenders, credit card companies, labor, etc.). Broad representation (in the academic world and in the public) and public access to deliberations is essential in order to militate against capture by business interests or even capture by a narrow slice of academics or intellectuals. The advisory council would hold at least one set of hearings prior to the approval or rejection of each financial product. If Congress or the Commissioner thought it necessary, different advisory committees could be created for different categories of financial products (e.g., credit cards and related instruments for one committee, near-term or payday lending arrangements for another).

Potential Drawbacks of this Proposal

Two potential concerns around this plan are (1) that it could limit financial innovation, particularly by smaller lenders with less ability to collect and supply data and to experiment, and, relatedly, (2) that it could limit consumer access to new financial products, not only in the absence of some products from the market but also the delayed arrival of new financial instruments. These are concerns that should be taken seriously, and indeed the Commission and the General Accounting Office and/or Office of Management and Budget should be required to report on indicators of whether innovation or other features of the retail financial market have been adversely affected.

⁶ I have argued elsewhere (“Protection without Capture,” *American Political Science Review* (2004); *The Forging of Bureaucratic Autonomy* (2001); “Regulation,” in the *Princeton Encyclopedia of American Political History* (2009)) that these concerns are often overstated in the academic literature and that many of the studies in which these conclusions rely are poorly done or lack evidentiary and methodological rigor. See also Scott James, *Presidents, Parties and the State* (Cambridge University Press, 2000), for the best study of the early Interstate Commerce Commission and Federal Trade Commission, one that sheds severe doubt about the capture of these agencies, at least in their early years of operation.

⁷ Scott Page, *The Difference: How the Power of Diversity Creates Better Groups, Firms, Schools, and Societies* (Princeton, 2007).

However, while a potential drawback, concern about the limitation of innovation is not necessarily a roadblock to this plan. We already regulate medical innovation very stringently and medical innovation has hardly suffered or fallen off a cliff. Again, the market-making capacities of regulation should always be kept in mind. Once bad products (“lemons”) are removed or deterred from the market, good products can take their place.

Moreover, it is also worth noting that the pre-approval process is not foreign to financial products. Before the deregulatory initiatives of the late Clinton Administration (December 2000), the Commodity Futures Trading Commission regulated the listing of contracts on public exchanges and required a pre-approval process for these financial products before they could be listed on the commodity futures exchanges.

Conclusion: Benefits of a Modified File-and-Use System with Elements of Prior Approval and with Post-Marketing Reports and Committed Data Collection

The potential advantages of this plan⁸ for consumer safety are many and have been discussed by other scholars and observers, most notably by Elizabeth Warren. Here, I would emphasize that just as important as the safety equation is the possibility that **this new regulatory scheme would create new and better markets**. A regulated market often possesses more information than an unregulated market, and *in these cases the crucial work of regulation is done by better-informed, more “market literate” consumers, and less by the government itself*. In other words, a good regulatory process does not put the government in a paternalistic position of the citizen’s sole protector. Instead, it allows citizens to better protect themselves.

⁸ Critically, the proposed modified file-and-use process need not solve all problems (or protect consumers perfectly) in order for it to “work.” And the institution set out here can be modified flexibly to incorporate other ideas.