Insight

On the Constitutionality of the FHFA and the CFPB

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Executive Summary

- In the wake of the financial collapse of 2008, the federal government created new regulatory bodies to oversee aspects of the financial services industry; most notably the Federal Housing Finance Agency (FHFA) and the Consumer Financial Protection Bureau (CFPB).
- From inception, scholars have questioned the constitutionality of both agencies, as they are significantly insulated from traditional oversight.

A Tyranny of Independent Agencies?

In Federalist No. 47, James Madison asserts, "The accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few, or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny."

Two federal agencies facing core constitutionality questions are the Federal Housing Finance Agency (FHFA) and the Consumer Finance Protection Bureau (CFPB). This January, the Supreme Court declined to hear a lawsuit that challenged the constitutionality of the CFPB. More recently, Acting Director of the FHFA Joseph Otting acknowledged the agency's own unconstitutionality under current law.

Given the increased prominence of questions surrounding the constitutionality of these financial regulators and their tremendous influence, it's important to understand both the claims against their constitutionality and the implications of such claims.

The Case Against the FHFA

Created in the midst of the housing crisis under the Housing and Economic Recovery Act of 2008 (HERA), the FHFA is the main regulator of two government-sponsored enterprises (GSEs), mortgage giants Fannie Mae and Freddie Mac. Beyond overseeing Fannie and Freddie, FHFA is mandated to ensure liquidity, stability, and access in the housing market.

In the flurry of the housing-market meltdown, Congress created the new agency in a way that left it without meaningful supervision. The FHFA has a single director who can only be fired "for cause" – failure to perform the job, actions of criminal behavior, or moral turpitude – unlike most agency heads who can be fired "at will." Congress went further to undercut its ability to maintain proper oversight by mandating that the FHFA be funded outside the traditional appropriations process. Alex Pollock of the R Street Institute has referred to the FHFA as an agency so independent that it's unconstitutional.

Last July, the U.S. Fifth Circuit Court of Appeals dealt a blow to the FHFA and these powers in a per curiam opinion, finding the agency's structure to indeed be unconstitutional. The Court found the FHFA's unusual composition compelling enough to rule the agency to be unlawfully structured and in violation of the separation of powers.

As the court noted:

> *Congress encased the FHFA in so many layers of insulation—by limiting the President's power to remove and replace the FHFA's leadership, exempting the Agency's funding from the normal appropriations process, and establishing no formal mechanism for the Executive Branch to control the Agency's activities—that the end 'result is a[n] [Agency] that is not accountable to the President.'*

Nevertheless, in August then-FHFA Director Mel Watt appealed the ruling and issued a request for an en banc rehearing of the case. Watt's term expired before the court could act and Comptroller of the Currency Joseph Otting was chosen to temporarily step in as Acting Director in December. In one of his first actions, Otting urged the Fifth Circuit to dismiss the case, essentially admitting the FHFA to be unconstitutional – a powerful statement from the agency's acting director.

Why does the FHFA's constitutionality matter? Under the leadership of former Director Mel Watt, the FHFA made extensive use of the powers granted to the agency by Congress. For example, the FHFA sponsored various pilot programs, spanning both single-family and multifamily lending, that gave preferential treatment to certain insurers in the mortgage market – a clear case where federal regulators picked winners and losers. Allegations of waste, fraud, and abuse at the FHFA became so concerning that it prompted the House

Committee on Financial Services to hold an oversight hearing last September.

The Case Against the CFPB

In a similar vein, questions about the constitutionality of the CFPB also focus on its structure. In the wake of the financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which, among a litany of other things, created the CFPB. Tasked with regulating the consumer finance industry, the CFPB works to increase and improve transparency, accountability, and consumer protections.

Hoping to isolate the CFPB from political pressures, Congress designed it to be led by a single director. Under this system the director is given near unilateral powers and can be removed by the president only in cases of "inefficiency, neglect of duty or malfeasance in office." This structure is quite unlike that of other financial regulators such as the Securities and Exchange Commission (SEC) or Commodity Futures Trading Commission (CFTC), which have five-person bipartisan boards. In seeking to isolate the Bureau from political pressures, Congress also determined that the CFPB be funded outside the traditional budgetary process. Note: much of this is reminiscent of the FHFA, no?

The most notable legal challenge to the constitutionality of the CFPB was PHH Corp. v. CFPB. In the first iteration of the suit, the D.C. Court of Appeals ruled the CFPB's structure to be unconstitutional.

The three-judge panel ruled that:

> *the CFPB departs from settled historical practice regarding the structure of independent agencies. And that departure makes a significant difference for the individual liberty protected by the Constitution's separation of powers. Applying the Supreme Court's separation of powers precedents, we therefore conclude that the CFPB is unconstitutionally structured because it is an independent agency headed by a single Director.*

The D.C. Circuit Court later decided to rehear the case en banc, however, and the court reversed its previous ruling, noting:

> *Wide margins separate the validity of an independent CFPB from any unconstitutional effort to attenuate presidential control over core executive functions….Because we see no constitutional defect in Congress's choice to bestow on the CFPB Director protection against removal except for "inefficiency, neglect of duty, or malfeasance in*

> *office," we sustain it.*

In a dissent to the ruling, then-Justice Kavanaugh of the D.C. Circuit, who wrote the original opinion overturning the CFPB's constitutionality, lamented both the ruling and the CFPB, writing:

Indeed, other than the President, the Director of the CFPB is the single most powerful official in the entire United States Government.…The CFPB violates Article II of the Constitution because the CFPB is an independent agency that exercises substantial executive power and is headed by a single Director. We should invalidate and sever the for-cause removal provision and hold that the Director of the CFPB may be supervised, directed, and removed at will by the President.

Despite this decision from one of the most influential appellate courts in the country, Chief District Judge Loretta Preska of the U.S. District Court for the Southern District of New York later ruled the CFPB to be unconstitutional in CFPB v. RD Legal Funding, an enforcement case brought by the CFPB, decided this past summer. Preska found that the CFPB's "composition violates the Constitution's separation of powers" and therefore "lacks authority to bring this enforcement action." Higher courts have yet to take any further actions on the suit.

Why does the CFPB's constitutionality matter? With limited executive control over the agency and without congressional power of the purse, unelected bureaucrats have been able to operate outside of the same constraints placed upon similar regulators. The burden the CFPB has placed on the financial system is not insignificant; the American Action Forum has found that to date, CFPB rulemaking has resulted in 30 finalized regulations which cost $3.1 billion and 24,251,630 paperwork hours. A 2017 report from the Competitive Enterprise Institute listed numerous examples of regulatory actions of the CFPB against mortgage, auto, and small-dollar lenders, which subsequently forced these firms to "pass on those costs on to consumers in the form of higher fees or reduced product choices." Furthermore, the CFPB played a central role in Operation Choke Point, an Obama-era initiative sponsored by the Department of Justice in conjunction with financial regulators that worked to cut the access of legal businesses—such as pawn shops, firearms dealers, and even dating services—to banking services. Threatening to bring down the full weight of their regulatory power onto banks who worked with such businesses, the CFPB was able to strongarm these financial institutions into dropping their accounts.

Conclusion

As the quote from Madison above implies, one central purpose of the Constitution was to constrain the institutions of government. While the size and scope of the federal government is always a cause for concern, the FHFA and CFPB deserve particular attention as the issue goes well beyond whether they're too big or too involved. It is hard to reconcile the FHFA and CFPB with the Constitution's separation of powers or checks and balances, as the agencies act as judge, jury, and executioner of the federal mortgage market and consumer finance. Politics aside, concern over the basic constitutionality of such central agencies should prompt apprehension from all actors in the system.