About this report

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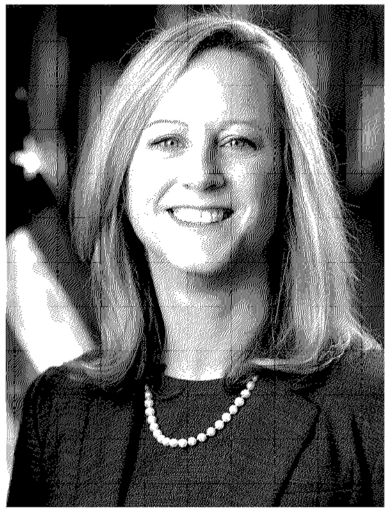
Message from the Director



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Sincerely,

[Exec Sec will add the signature during the clearance process.]

Kathleen L. Kraninger

Message from the Taskforce

The Consumer Financial Protection Bureau Taskforce on Federal Consumer Financial Law (Taskforce) is pleased to present you with this final Report as Director of the Consumer Financial Protection Bureau (Bureau).

As provided in the Taskforce Charter, you requested that we "provide an objective and independent evaluation, in the form of one consensus final report to the Director, of the Bureau's current regulatory framework," to "examine the existing legal and regulatory environment facing consumers and financial services providers," and to "report its recommendations for ways to improve and strengthen consumer financial laws and regulations." Finally, as required by our Charter, we have delivered our final Report by January 2021. We hope to have succeeded in meeting the goals and expectations in establishing the Taskforce.

The Report was researched and authored by five Members, one of who served as Chair of the Taskforce; and six support staff, overseen by a Staff Director. As requested, this Report reflects the consensus views of the Taskforce Members. Moreover, given the nature of the Taskforce, the views espoused in the Report may not be representative of current Bureau positions or policy.

To fulfill the scope our charter, the Taskforce has published a two-volume report. The Volume I contains reference to original empirical data, information, and analyses, and can be broken into three sections:

1. A historical and economic overview of consumer finance;

2. The framework of consumer financial protection: consumer protection, competition, innovation, and inclusion; and

3. Modernizing the regulatory framework and expanding consumer empowerment.

We used the insights gained to develop Volume II, which contains recommendations. Our recommendations proposed seek to improve the lives of every American consumer, regardless of race, creed, gender, ability, or status, with the important focus on improving access, inclusion, and choice for all Americans.

Each member brought unique experiences and views and is impressively accomplished, well respected, and immensely capable in the field of consumer financial protection and Federal consumer financial law. To fulfill the Taskforce mandate, the Members leveraged their combined 150 years of professional experience as well as the extensive expertise that exists within and outside of the Bureau. The Taskforce is especially grateful for the tireless and valuable contributions of Taskforce support staff, who were encouraged to contribute their personal experiences and professional expertise into the conversation. The final Report was improved immensely by their contribution to the Taskforce deliberations and production. The Members, however, own all responsibility for the final analysis and recommendations in the Report.

Every American has a stake in a fair, efficient, and modern system of consumer finance. Given the limited number of positions on the Taskforce, tremendous effort was taken to ensure the great diversity of the American consumers' views, opinions, and experiences were given voices. To achieve this end, a particular objective of the Taskforce was to seek as much valuable public input as possible, a goal that immediately became challenging as a result of the onset of the global health pandemic just weeks after the Taskforce began its deliberations.

Despite these challenges, the Taskforce redoubled its efforts to seek public contribution through written comments and virtual engagements with stakeholders inside and outside the government, information which is included throughout the final Report. Indeed, writing the report in real time as consumers and regulators rose to the challenge of responding to the pandemic and its economic effects constantly reminded the Taskforce of the importance of protecting and empowering consumers as well as ensuring a modern and resilient consumer financial protection framework that can swiftly respond to the needs of America's consumers. The Taskforce issued a Request for Information; conducted a robust public research effort; met with trade, consumer advocates, academics, and the Bureau's advisory committees in meetings listened to by hundreds of public observers; and conducted over twelve intergovernmental engagements with partner state and federal regulators to hear as many perspectives as possible. Economic analyses and empirical research are the foundation of this report, and it advocates for the interest of only one stakeholder – the consumer.

Finally, the Taskforce Members and staff would like to express our appreciation to you for trusting us with this charge to recommend ways to improve the operation of the nation's system of consumer financial law. We also would like to recognize and express our appreciation to all the Bureau staff who assisted the Taskforce throughout the research and writing of the Report. The commitment of Bureau staff to open dialogue and engagement in a shared mission to improve the consumer financial regulatory system is a testament to the commitment of Bureau employees to improving the lives of American consumers. The Taskforce would like to especially thank Deputy Director Brian Johnson, Acting Deputy Director Leonard Chanin, and Deputy Director Tom Pahl for their support of the Taskforce and its mission.

In the decade since it was formed from the ashes of the 2008 financial crisis, the Bureau has grown from a startup to a powerful champion for the American consumer. As part of its deliberations, the Taskforce surveyed the Bureau's activities in the ten years since its founding. The Appendix to the Forward of Volume I of this report provides a summary of some of the major accomplishments. The list is impressive and wide-ranging, covering all the Bureau's tools and functions. The Taskforce is honored to be part of this legacy and to contribute to the Bureau's continued success.

Respectfully,

Todd J. Zywicki, J.D.
Taskforce Chair

J. Howard Beales, Ph.D.
Taskforce Member

Thomas A. Durkin, Ph.D.
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William C. MacLeod, J.D.
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Foreword

One hundred years ago marked the dawn of the modern American consumer financial system, as increasing urbanization and the emergence of a wage economy led the Russell Sage Foundation to call for national efforts to erect a new regulatory framework that would better meet the needs of American workers. Fifty years ago, the National Commission on Consumer Finance (NCCF) was convened in response to the emerging national structure of consumer financial markets and the growing need for a larger federal regulatory presence to address those challenges. Today, as revolutions in technology, the economy, and consumer preferences raise new opportunities and threats for American consumers, it is a propitious time to once again review the framework of consumer financial protection.

The Taskforce firmly believes that robust federal enforcement is essential to effective consumer protection. Markets are important and cannot be ignored in the effort to maximize consumer welfare as judged by consumers. But, as recognized in the previous assessments, markets are not enough. Government has a crucial role to play in ensuring that the financial system delivers products and services that are fairly priced, with reasonable terms, and available to all consumers.

The Report is organized in two volumes. Volume I provides a historical and economic overview of consumer finance, covers the key principles that form the core of federal consumer financial law and policy, and discusses particular topics that are important to the Bureau's work. Volume II develops recommendations to improve and strengthen the application of financial laws and regulations. Recommendations are grouped in alphabetically listed topics.

In drafting the Report, the Taskforce has been animated by three overarching principles. First, consumer protection policy should be particularly attentive to the consequences for inclusion and access by those communities that have previously been underserved. Toward that end, an essential element of policy should be to facilitate competition, innovation, and consumer choice in the marketplace. Second, consumer financial protection policy should be focused on avoiding harms to consumers rather than attempting to specify how providers should design and market their products. Third, the existing regulatory framework needs modernization to enable it to adapt more nimbly to changes in technology and consumer preferences, respond to new opportunities and threats to consumers, and address future crises, such as the 2008 financial crisis that spawned calls for the Bureau's creation and the 2020 Coronavirus pandemic.

The report is organized around the key areas of analysis of consumer protection: the legal framework of consumer protection, information and disclosure, competition and innovation, inclusion and access, and regulatory modernization.

First, in analyzing the legal framework of consumer protection, the report focuses on implementing the goal of minimizing consumer harm through effective regulatory policies that protect consumers, promote the fair and efficient operation of markets for the benefit of consumers; and the report identifies the optimal use of the five regulatory tools available to the Bureau in executing its duties (enforcement, regulation, supervision, financial education, and policy research and development). The report also recommends the Bureau reorganize around the markets it regulates rather, than the tools it implements with an eye toward efficiently minimizing consumer harm.

Second, the report identifies the role of consumer information and disclosures in promoting consumer protection and welfare. Since the enactment of the Truth-In-Lending Act, disclosure and information provision to consumers has been a primary focus of the consumer financial protection system. Today, however, consumers are overwhelmed by a blizzard of information and disclosures, which are often required for a variety of different and often contradictory purposes. The Taskforce believes that policymakers should review the current disclosure regime to focus shopping-related disclosures on the central goal of promoting informed choice by consumers. Disclosure policy should be reviewed and modernized, where appropriate, to facilitate electronic disclosures aimed at providing consumers with the relevant information needed at the moment of decision. Finally, the report also stresses that although information can be useful to promote consumer choice and competition, it is equally important that policymakers be cognizant of the limits of consumer attention and that *pro forma* notice and consent by consumers should not be a substitute for agency action to protect consumers from harm.

Third, the Taskforce emphasizes that an essential organizing structure of the consumer financial system should be an emphasis on competition, innovation, and consumer choice. Since the NCCF report fifty years ago, the development of the consumer financial system has contributed to widespread prosperity, autonomy, and material comfort. Competition and innovation have produced lower prices, greater variety, and expanded choice, putting bank accounts and credit cards within reach for millions of consumers for the first time in American history. To facilitate competition and innovation, the Taskforce recommends enabling non-bank institutions to provide a greater array of financial services, including authorizing nonbank payment systems, reducing regulatory obstacles to chartering of industrial loan companies, and expanding the opportunities for credit unions to serve low-income communities. Finally, the Taskforce recommends that the CFPB be authorized to grant charters to non-depository FinTech companies, payments processors, and other financial service providers that operate in inherently interstate markets.

Fourth, the Taskforce believes that increasing financial inclusion and access to products and services on fair and reasonable terms is a moral imperative and should be a central focus of consumer financial regulatory policy. Although the innovations and developments of recent decades have brought quality financial services at competitive prices into the hands of middle class consumers, some consumers remain on the margins of the system, including those who are "credit invisible" or lack the resources or knowledge to navigate the consumer financial system successfully. A first step toward promoting greater inclusion involves continued vigilance to attack barriers to inclusion based on characteristics such as race or sex, but policymakers should consider expanding those protections to other characteristics, such as disability. The Taskforce also believes that policymakers should consciously adopt policies that will facilitate greater inclusion, such as creating a modern regulatory framework for FinTech firms, facilitating use of alternative data, allowing greater use of industrial banking charters for commercial providers of financial services, and adopting a faster payments clearing system. In addition, the Taskforce also recommends that policymakers reconsider existing laws and regulations that adversely affect financial inclusion, such as price controls on debit card interchange fees at larger banks, that interfere with the ability of credit card issuers to adjust terms when a consumer's risk profile changes, and that impede offering cards to consumers who currently have difficulty accessing credit.

Finally, the onset of the Coronavirus pandemic contemporaneously with the Taskforce's deliberations has highlighted the urgent need for a flexible, nimble, and adaptive consumer financial protection system. Innovation and technical change have always been drivers of reform in consumer financial protection law. For example, the declining cost of long-distance telephone calls, the growth of national department stores and credit-granting practices, and the increase of interstate mobility of consumers in the post-World War II era created the need for a larger federal role in consumer financial protection beginning in the 1960s. Today, the pace of change in technology and consumer preferences has accelerated, putting even greater pressure on the need for adaptability to protect consumers from rapidly emerging threats to their privacy, data security, and financial well-being. In addition, this rapidly emerging environment places an enhanced premium on the need for consumers to have the tools of financial knowledge and literacy to take advantage of these innovations when appropriate. Although unprecedented in its nature, the Coronavirus pandemic has illustrated the need for a financial system that is resilient enough to respond nimbly to emergent crises through the design of its institutions and content. The report recommends that to promote a more responsive regulatory structure, financial regulators should make greater use of principles-based regulation, consider the efficient mix of the Bureau's regulatory tools, and establish authorities and procedures for responding to crises in a predictable fashion.

Some important sectors and topics are not addressed at length. The Members used a three-pronged test to help determine the scope of the report: (1) was a sector or subject already substantially and adequately addressed by recent activity by the Bureau or some other source, (2) did the Members possess a comparative advantage in offering insights or was it beyond the scope of expertise or the Taskforce's charter, and (3) did the Taskforce have something meaningful or constructive to contribute to identifying important problems and possible solutions? For example, mortgages and mortgage service providers are hugely important topics for consumers and the economy; nevertheless, they are only covered tangentially given the recent and extensive modernization efforts the Bureau has undertaken since its inception, as noted in Appendix A to this Foreword. Due to the time-limited nature of the Taskforce's work, numerous recommendations suggest further research and deliberation before developing a position. The importance of topics should not be measured by the number of pages or recommendations devoted to them, and the potential for improving consumer financial protection should remain a perennial subject of reexamination.

This report seeks to make the complex subjects of law, economics, and consumer financial protection approachable and easy to understand. Readers will notice that the background and recommendations are written in plain language while scholarly studies, analyses, and denser material can be found in footnotes and references. Policy makers should consider the report in totality, but other readers will not be lost should they choose to review a single chapter or section. Important themes are repeated to help accomplish this goal.

The research and analysis presented in Volume I is a framework for thinking about consumer financial protection law and economics. It is intended to lay a foundation of knowledge and principles to which policymakers, Bureau employees, and the public can return as new issues in consumer finance and financial protection arise. It may also serve as foundational thinking or guiding principles for future Bureau actions (rule makings, supervisions or enforcement actions, assessments, research, policy guidance, consumer education, et cetera).

Volume II is more pragmatic and temporal in nature. The recommendations are being made at a point in time. Government executives, policy makers, and their staff should consider how the current financial regulatory regime and framework has evolved when viewing these recommendations in the future.

The members of the Taskforce are grateful for the opportunity that we have been provided to undertake this report on behalf of the American people. The insights of the NCCF's report fifty years ago shaped consumer financial protection policy for decades to come—indeed, the NCCF report called for the creation of a consumer financial protection regulator much like the one that later became the CFPB. As the Bureau celebrates its 10th Anniversary and looks forward to the next fifty years, the Taskforce hopes that our contributions may prove equally long lasting.

FOREWORD, APPENDIX A:

Bureau highlights: A 10-year review

The Taskforce wanted to note that the Bureau has had significant success since its start nearly ten years ago. Through the lens of the tools granted to the Bureau by Congress (enforcement, rulemaking, supervision, research, education) this appendix highlights a (non-exhaustive) list of those successes.

Enforcement

- Since its founding, Bureau public enforcement actions have resulted in over $12.9 billion in total consumer relief (over $5.8 billion in consumer redress and over $7.1 billion in other relief) and over $1.5 billion in civil money penalties, before adjusting for suspended amounts.[2]
- So far in 2020, the Bureau announced 42 public enforcement actions, settling 3 previously filed lawsuits and actions ordering nearly $670 million in total consumer relief and over $90 million in civil money penalties, before adjusting for suspended amounts.
- Enforcement actions have been taken to address law violations in connection with consumer financial products and services. These actions targeted Bureau-regulated banks, loan servicers, debt collectors as well as entities in the fair lending arena. Through enforcement, the Bureau has also sought to protect servicemembers and students from deceptive practices.[3]

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[2] Consumer Financial Protection Bureau, *Payments to Harmed Consumers* (Dec. 2020) (https://www.consumerfinance.gov/enforcement/payments-harmed-consumers/)

[3] Consumer Financial Protection Bureau, *Rules Policy* (n.d.) (https://www.consumerfinance.gov/rules-policy/)

- Through the Bureau's Office of Innovation, the Bureau has promoted innovation in markets for consumer financial products and services. The office has created a streamlined No-Action Letter (NAL) application process, resulting in nine approved NAL's or NAL templates since 2019.[4] These letters have helped bring regulatory certainty to the marketplace.

- The Office of Innovation has also helped bring together technologists with financial, consumer, and regulatory stakeholders at Tech Sprints.[5] These events are dedicated to creating technology-focused solutions to a variety of regulatory and consumer protection challenges. The first Tech Sprint was held in October 2020, with teams focused on developing new approaches to electronically delivered adverse action notices.

- The CFPB's Office of Fair Lending has worked to make financial products and services more accessible to consumers who are unbanked and underbanked, including those who are Limited English Proficient (LEP). The office has also advocated the use of alternative data in underwriting, seeking to expand fair, equitable, and nondiscriminatory access to credit.[6]

Rulemaking

- Part of the Bureau's role is to implement and enforce consumer financial laws. Since 2012, the Bureau has finalized dozens of rules ensuring all consumers have access to markets for consumer financial products and services that are fair, transparent, and competitive. The rulemaking process receives substantial public input from all stakeholders before the rule is finalized.[7]

- Finalized rules have focused on establishing clear rules of the road for financial institutions and consumers alike. These rules have helped define and clarify federal consumer financial law in areas such as payday lending, debt collection and mortgage lending.

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[3] Consumer Financial Protection Bureau, *Granted Innovation Applications* (n.d.) (https://www.consumerfinance.gov/rules-policy/innovation/granted-applications/)

[4] Consumer Financial Protection Bureau, *CFPB Tech Sprints* (n.d.) (https://www.consumerfinance.gov/rules-policy/innovation/cfpb-tech-sprints/)

[5] Office of Fair Lending, 2019 *CFPB Fair Lending Report* (April 2020) (https://files.consumerfinance.gov/f/documents/cfpb_2019-fair-lending_report.pdf))

[7] Consumer Financial Protection Bureau, *Final Rules* (n.d.) (https://www.consumerfinance.gov/rules-policy/final-rules/)

- The Bureau has also become a coordinating member of the Global Financial Innovation Network (GFIN), a world-wide effort to promote financial innovation that benefits consumers.[8]

Supervision

- Hundreds of commissioned Bureau examiners supervise banks, thrifts and credit unions with assets over $10 billion to ensure compliance with federal consumer financial laws.[9] The Bureau also has supervisory authority over nonbank mortgage originators and servicers, payday lenders, and private student lenders of all sizes.

- The Bureau releases Supervisory Highlights throughout the year to share key examination findings which help the industry limit risks to consumers and ensure compliance with federal consumer financial law.[10]

- The Bureau has provided Advisory Opinions and supervisory guidance to advise and assist regulated entities to better understand their legal and regulatory obligations.[11] Advisory opinions on earned wage access, private education loans and special purpose credit programs have helped promote regulatory certainty.

Research

- Using data collected from consumer complaints and regulated entities, the Bureau has conducted research and published reports on important topics including consumer credit trends, mortgage delinquency rates and the overall financial wellbeing of consumers.[12] These reports and research have been cited in hundreds of publications.

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[8] Consumer Financial Protection Bureau, *The CFPB and the Global Financial Innovation Network* (n.d.) (https://www.consumerfinance.gov/rules-policy/innovation/global-financial-innovation-network)

[9] Consumer Financial Protection Bureau, *Institutions, Supervisory Examinations* (n.d.) (https://www.consumerfinance.gov/compliance/supervision-examinations/institutions/)

[10] Consumer Financial Protection Bureau, *Supervisory Highlights* (n.d.) (https://www.consumerfinance.gov/compliance/supervisory-highlights/)

[11] Consumer Financial Protection Bureau, *Advisory Opinion Program* (n.d.) (https://www.consumerfinance.gov/compliance/advisory-opinion-program/)

[12] Consumer Financial Protection Bureau, *Data & Research* (n.d.) (https://www.consumerfinance.gov/data-research/research-reports/)

- The Office of Research has completed five-year retrospectives on Bureau rules to examine their impact and provide recommendations. Assessments have been conducted on TRID, Ability to Repay/QM and remittance rules.[13]

Education

- *Ask CFPB* has received over 13 million unique visitors since its launch in 2012, answering hundreds of unique consumer questions.[14]
- The Bureau has handled more than 2.5 million consumer complaints since 2011[15]. More than 5,000 financial companies have responded through this process, providing timely responses to 97 percent of the more than 1.6 million complaints sent to them for response.
- During the COVID-19 pandemic, the Bureau handled tens of thousands of consumer complaints, helped set up an interagency housing assistance page, and created over 70 COVID-19 specific resources for the public to view on its website which were viewed by more than four million users.[17]
- The Bureau has established a consumer complaint database for the public to view this complaint data, with a new Trends view that allows users to sort and filter data. The Bureau has also created partnerships with the Federal Housing Finance Agency and the Department of Education to share this data to help draw conclusions about borrowing.[16]
- The Bureau, through initiatives such as *Your Money, Your Goals* and *Smart Small, Save Up*, has created innovative new tools that help consumers navigate financial decisions involving loans, savings, taxes and more.[17] These resources have helped consumers in

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[13] Consumer Financial Protection Bureau, *Kraninger Marks Second Year as Director of the Consumer Financial Protection Bureau* (Dec. 2020) (https://www.consumerfinance.gov/about-us/newsroom/kraninger-marks-second-year-director-consumer-financial-protection-bureau/)

[14] Consumer Financial Protection Bureau, *CFPB By the Numbers 2016* (Jan. 2017) (https://files.consumerfinance.gov/f/documents/201701_cfpb_CFPB-By-the-Numbers-Factsheet.pdf)

[15] Consumer Financial Protection Bureau, *CFPB Announces New Capability for the Consumer Complaint Database, Expands Ability to View Complaint Data Over Time* (July 2020) (https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-new-consumer-complaint-database-capability/)

[16] Consumer Financial Protection Bureau, *Kraninger Marks Second Year as Director of the Consumer Financial Protection Bureau* (Dec. 2020) (https://www.consumerfinance.gov/about-us/newsroom/kraninger-marks-second-year-director-consumer-financial-protection-bureau/)

[17] Consumer Financial Protection Bureau, *Consumer Tools* (n.d.) (https://www.consumerfinance.gov/consumer-tools/)

vulnerable financial situations such as servicemembers, older Americans, and college students.

- As part of these efforts, the Bureau has distributed hundreds of thousands of copies of educational materials across the United States. The Bureau has trained thousands of professionals in intermediary organizations on how to use these materials and connect with key communities.[18]

- Recent reports have studied HMDA data points to find mortgage trends[18], and the credit records of young servicemembers and veterans.[19]

[18] CFPB Office of Research, *Data point: 2019 mortgage market activity and trends* (June 2020) (https://www.consumerfinance.gov/data-research/research-reports/data-point-2019-mortgage-market-activity-and-trends/)

[19] CFPB Office of Research, Data point: Debt and delinquency after military service: A study of the credit records of young veterans in the first year after separation (Nov. 2020) (https://www.consumerfinance.gov/data-research/research-reports/debt-and-delinquency-after-military-service-study-credit-records-young-veterans-first-year-after-separation/)

1. Introduction

On October 11, 2019, the Consumer Financial Protection Bureau (CFPB) announced its plan for a Taskforce on Federal Consumer Financial Law. According to the announcement, the Taskforce "will examine the existing legal and regulatory environment facing consumers and financial services providers and report recommendations on ways to improve and strengthen consumer financial laws and regulations to CFPB Director Kathy Kraninger." The announcement continued:

The Taskforce will produce new research and legal analysis of consumer financial laws in the United States, focusing specifically on harmonizing, modernizing, and updating the enumerated consumer credit laws – and their implementing regulations – and identifying gaps in knowledge that should be addressed through research, ways to improve consumer understanding of markets and products, and potential conflicts or inconsistencies in existing regulations and guidance.

The Taskforce is in part inspired by an earlier commission established by the Consumer Credit Protection Act (Act) in 1968. In addition to various changes to consumer law generally, the Act established a national commission to conduct original research and provide Congress with recommendations relating to the regulation of consumer credit. The commission's report contains original empirical data, information and analyses – all of which undergird the report's final recommendations. The data, findings, and recommendations from the commission were all made public, and the report led to significant legislative and regulatory developments in consumer finance.

This announcement raises three immediate questions:

1. what was the earlier commission the announcement cited;
2. what did it recommend, and
3. what is the intent of the new Taskforce in more detail?

1.1 The National Commission on Consumer Finance

The earlier commission was the National Commission on Consumer Finance (NCCF or Commission), established by Title IV of the Consumer Credit Protection Act of 1968 to study consumer credit. This was the same Act that established Truth in Lending as Title I. After time spent holding hearings, gathering and analyzing data, and undertaking legal reviews, the NCCF issued its final Report on December 31, 1972 (Consumer Credit in the United States: The Report of the National Commission on Consumer Finance). Well known in its time and widely available in print from the Government Printing Office, the Report is less well known now after almost five decades, but it remains a landmark in the development of consumer credit research and regulation.

The National Commission undertook its review about fifty years after the beginnings of modern consumer credit in the United States. Credit used by individuals is known from antiquity, but newer forms began to develop after the Civil War. 1870 to 1920 can be considered the "premodern" period of domestic consumer-credit development.

This premodern period witnessed a large-scale movement of individuals from rural areas and family farms to growing urban areas. Railroad development improved transportation, which encouraged wider markets and industrialization. Industrialization and urbanization led to a variety of new jobs, both blue-collar and white. This also meant that for the first time in history large numbers of new industrial employees like day laborers, machinists, plumbers, steamfitters, bookkeepers, office workers, retail clerks, and others with small immediate families now lived apart from extended families. Many did not even know their new neighbors, at least not very well. This meant they sometimes had to face various financial needs and emergencies alone without wider support and encouragement. Waves of immigrants during these years found themselves even farther from families still in the old country, often with extremely limited resources to fall back upon.

But these economic changes also encouraged further economic development based more on urban wage-earning than on rural agriculture. Steadier sources of financial income for many families sometimes allowed for some of their income to be pledged for debt repayments. In effect individuals discovered the possibility of converting their main asset, their income from employment, in ways that better met their needs. Credit use could help manage some emergencies among industrial workers, but it also encouraged slow development of a more middle-class lifestyle among upwardly mobile population segments. Sewing machines from the Singer Company, coal stokers, pianos and parlor organs for home entertainment, and factory-built furniture became popular purchases "on time." Though credit use was frowned upon by many during the Victorian years (especially among wealthier members of society who criticized social striving and alleged profligacy of the working class and emerging middle class for material goods), credit use continued to increase, nonetheless.[1]

Interest-rate ceilings in all the states at the time made it difficult for potential lenders to provide credit to individuals profitably, so credit sources were limited. Rate ceilings dated to the British legal traditions imported into America during colonial times, although they had been repealed in England by this time. Lenders working outside the law were the common source of cash loans for necessities and emergencies during these years. Some of these lenders were what we might otherwise consider legitimate businesses but operating outside the rate ceilings. The need to operate outside any law does not encourage widespread entry by legitimate businesses though, and so the prevailing market conditions also encouraged entry by less-reputable lenders who sometimes engaged in various sharp practices.[2]

The other common sort of consumer credit during these years involved sale of specific goods with payment accepted over time. Court decisions determined that sellers could charge one price for payment now and a different price for payment later without transaction being considered a loan -- the price difference would be considered a "time-price differential." Since it was not interest under the law as interpreted by the courts, it was not subject to interest-rate ceilings. Again, although there were many legitimate credit sellers, this situation also sometimes produced failures of transparency and unsavory practices.

Beginning about 1910, reformers began to take aim at the need for changes in provision of consumer credit. Credit used by individuals was still regarded as somewhat disreputable, but better understanding of its benefits. Reform efforts, especially on the cash-lending side, became a goal of the social-reform-oriented Russel Sage Foundation. The Foundation argued for legal and transparent, regulated markets for cash loans rather than illegal lending. Besides

[1]Cultural aspects of emerging consumer credit use are extensively and ably discussed by Lendol C. Calder in *Financing the American Dream*, referenced in the following footnote.

[2]This premodern period is sometimes called the "loan shark" period of domestic consumer credit. For extended historical review of lenders and lending during these times, *see* LOUIS N. ROBINSON AND ROLF NUGENT, THE REGULATION OF THE SMALL LOAN BUSINESS (New York: Russell Sage Foundation, 1935); IRVING S. MICHELMAN, CONSUMER FINANCE: A CASE HISTORY IN AMERICAN BUSINESS (New York: Augustus M. Kelley, 1970); *see also* LENDOL C. CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT (Princeton, NJ: Princeton University Press, 1999); ROSA-MARIA GELPI AND FRANCOIS JULIEN-LABRUYERE, THE HISTORY OF CONSUMER CREDIT (New York: St. Martin's, 2000); ELIZABETH ANDERSON, *Experts, Ideas, and Policy Change: The Russell Sage Foundation and Small Loan Reform, Theory and Society*, 37, 271 (2008*); and* ANNE FLEMING, CITY OF DEBTORS (Cambridge, MA: Harvard University Press, 2018). It is interesting to note that the subtitle of Robinson and Nugent's 1935 book for the Russell Sage Foundation about overcoming illegal lending indicates how important they thought the reform effort was: "A detailed account of the growth and regulation of a business which is of peculiar importance in our social structure."

introducing systematic study of the consumer-credit phenomenon, it drafted a model reform law for the states and by 1916 began lobbying effectively for its passage. Eventually, almost all states instituted its recommended reforms in some manner.

Commercial enterprises also saw the advantages of reforms in the credit area. Potential cash lenders looked for a way to enter markets legally and supported the Sage Foundation's reform efforts to eliminate illegal lenders. By 1920, new industries like automobile manufacturers also saw the clear advantage of eliminating abuses in financing so they could sell more output profitably.[3]

These actions among reformers, lenders, manufacturers, and legislators, along with changing societal attitudes toward their efforts in the credit area, supported the beginnings of the "modern period" of consumer credit. Growth of credit for durable goods like automobiles, refrigerators, radios, and others began to be important in the 1920s and 1930s.[4] At the same time, states began systematic revision of rate-ceiling regulations to permit better credit access, although not necessarily consistently across states or even within them.

Consumer credit growth became much more rapid after World War II, with growing prosperity after the war and extensive movement of population to the new suburbs. In addition to substantial economic and consumer credit growth after the war, the period also witnessed further changes in credit regulation at the state level. The first half of the modern period for consumer credit ended with implementation of the first consumer-credit protection law at the federal level (Truth in Lending, effective July 1, 1969) and review of both credit growth and regulation by the NCCF in 1971-2.

In many ways, the Commission and its Report provide both a landmark and a good starting point for the work of the current Taskforce. The NCCF undertook its work just a little over halfway between start of the modern period and the present, about fifty years after early attempts by the Russell Sage Foundation and state legislatures to establish systematic regulation of the new phenomenon of institutional consumer credit. The Commission's work came at the beginning of what we might call the "mature phase" of consumer credit when access to credit

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[3]As indicated, under the laws of most states, purchases of specific goods and services with payment over time legally were not loans but were "installment sales" and were regulated differently from loans of money. Consequently, strictly speaking, not all *consumer credit* historically consisted of *consumer loans* and the terms *consumer credit* and *consumer loan* were not interchangeable. For most purposes today, this old legal distinction between "credit" and the narrower term "loan" is no longer relevant and so this report adopts the common modern convention of using the terms consumer *loan* or consumer *lending* interchangeably with consumer *credit*. The Federal Reserve has always included both kinds of credit in its comprehensive statistical series on consumer credit that began in 1943.

[4]See also MARTHA OLNEY, BUY NOW, PAY LATER: ADVERTISING, CREDIT, AND CONSUMER DURABLES IN THE 1920S (Chapel Hill, NC: University of North Carolina Press, 1991).

became democratized, markets became national rather than local, sometimes technological rather than personal, and regulation became increasingly federal. The following chapters will quote liberally from the National Commission's Report from time to time, due to the Commission's key position near this halfway point of modern consumer credit to date and the opportunity to articulate the consistencies in economic and legal thinking on credit topics over time. The overarching goals of both the Commission and this Taskforce are to reexamine how change and pace of change in the consumer-financial area are impacted by the regulatory structure that has developed around them. The Taskforce more than the NCCF also looks at innovation, change, and legal issues in the depository and money-transfer side of consumers' finances.

The Commission's charge from Congress in 1968 was broad, its review and background work was extensive, its establishment of the central questions was thoughtful, and its coverage of the charge and questions was comprehensive at the time. The Report, its footnotes, and the accompanying studies provide a good review of the state of knowledge of consumer credit markets and institutions in the early 1970s. Moreover, through its work, the NCCF established a framework for the development of the next several decades of consumer finance policy and research. Despite occasional discussion over the years of reestablishing a commission or something similar in the consumer financial area, nothing similar has been undertaken until now.[5]

The NCCF developed its analysis and recommendations over 294 pages of the Report and six additional published volumes of technical studies, but its overarching themes for consumer credit markets are easily visible:

- Allow the benefits of credit inclusion to reach all consumers.
- Ensure effective and efficient consumer protection rules and regulations that will maximize consumer welfare.
- Enhance competition in the marketplace encouraging choice.
- Promote consumer sovereignty through information.

[5]For instance, in 1992, the Federal Financial Institutions Examination Council (FFIEC) recommended a narrowly-focused commission in its *Study on Regulatory Burden* (p. IV-2). The context of the recommendation indicates the recommendation included consumer- protection regulation: "An independent, nonpolitical group or commission charged with exploring possibilities for easing regulatory burden through broad political consensus could also be helpful. Such a commission could have limited life, be free of political partisanship, and be charged with making a comprehensive examination of all aspects of regulatory burden, especially that burden imposed through legislative mandates."

- Create a modern regulatory framework and institutional structure to achieve those results.

- Appendix A to this Introduction provides further review of the NCCF's Report and lists its specific recommendations. Appendix B includes Commission members, its Report Foreword, staff, and its list of technical studies.

1.2 The Taskforce on Consumer Financial Law

Now the current Taskforce has received a similar charge to look at consumer-financial conditions and law after the second half of the current modern period, following fifty more years of changes. Although consumer credit necessarily continues as an important focus of the Taskforce's work, its scope is wider than the Commission's and includes more generally financial services on the consumer asset side, including payments products and services. Taskforce members were officially appointed in January 2020 and convened on January 29th for the first orientation to meet with the Director and Deputy Director to discuss the Taskforce charter. The Taskforce's charter specifies that it reports to the Director and will provide its report by January 2021.

The charter also says that the Director would appoint the Chair of the Taskforce and designate a Staff Director to "ensure that the Taskforce operates in accordance with the terms of the charter, in addition to other responsibilities delegated by the Director." The Director appointed Todd J. Zywicki, J.D., Professor of Law at George Mason University as Chair of the Taskforce and Matthew Cameron of the CFPB staff as initial staff director. J. Howard Beales, Ph.D., Thomas A. Durkin, Ph.D., William C. MacLeod, J.D., and Jean Noonan, J.D. were members of the Taskforce and who became employees of the CFPB. The membership and staff of the Taskforce are listed together in Appendix C to this chapter.

The charter also designates the Objective, Scope, and Duties of the Taskforce:

- The Taskforce will 1) examine the existing legal and regulatory environment facing consumers and financial services providers; and 2) report its recommendations for ways to improve and strengthen consumer financial laws and regulations, including recommendations for resolving conflicting requirements or inconsistencies, reducing unwarranted regulatory burdens in light of market of technological developments, improving consumer understanding of markets and products, and identifying gaps in knowledge that should be addressed through future Bureau research.

- The duties of the Taskforce are to provide an objective and independent evaluation, in the form of one consensus final report to the Director, of the Bureau's current regulatory framework. The findings should identify where there may be gaps or where regulation should be simplified or modernized to help the Bureau more effectively carry out the mission of protecting consumers.

The Taskforce discussed this charter with the Director on January 29, 2020 and held an organizational meeting January 30-1. The Taskforce members responded enthusiastically to the project ahead and began delegating and dividing responsibility for leadership on the various components and chapters of a preliminary plan it outlined for the report to come. One of the first matters of business was to construct a plan for extensive outreach for information from the public, interested organizations, including consumer and trade groups, the Bureau's Advisory Councils, and other federal and state governmental agencies. At the next planning meeting in early March, the Taskforce designed a specific public Request for Information (RFI) and a series of meetings, listening sessions, and public hearings.

Unfortunately, the onset of the COVID-19 pandemic closed the Bureau's Washington headquarters the day after the outreach-planning meeting and dispersed the staff and large segments of the public to shelter-in-place status, causing havoc with the outreach plan for months. This meant that the Taskforce had to alter its outreach to later in the year and resulted in a more condensed version than anticipated.

At the January organizational meeting, the Taskforce had the opportunity to discuss the kinds of changes that had taken place in consumer financial services since the NCCF Report. Differences included widespread new technologies in the financial area, substantial increases in the amounts of credit in use, and a notable increase in federal regulatory efforts in a variety of areas. At the time of the NCCF, there was only one federal law directly aimed at consumer credit (Truth in Lending). Today there are eighteen major federal regulatory laws in the consumer area and a Federal Consumer Financial Protection Bureau established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010.

This discussion caused the Taskforce at its outset to look at the NCCF's findings again, with a new eye in a new technological era with new laws and regulations. At the same time, the Taskforce acknowledged the NCCF's importance and throughout this report the Taskforce broadly urges ongoing efforts of attention and renewal to the key areas the NCCF identified and were outlined above:

Continuing focus on inclusion by encouraging access to financial services through competitive markets;

- Consumer protection that eliminates archaic legal and illegal practices;

- Enhancing competition with new technologies;
- Improving consumer information and education; and
- Modernizing and rationalizing the regulatory structure that oversees consumer financial protection.

Providing for these needs and appropriate regulation in an economy as large, dynamic, and diverse as in the United States will always be a challenge requiring constant attention. Furthermore, advancing recommendations in these areas will always involve open-minded consideration of tradeoffs. For instance, empowering consumers to make their own choices can sometimes result in difficult outcomes for some of them. Likewise, banning products to protect some can reduce the welfare of others. Restricting new sorts of untried products or technologies may also restrict or minimize development of many cost and time-saving advantages, and so on.

As this Taskforce and its report focus on these central themes and lesser ones, and they continue to look at many specific questions raised by the NCCF in 1972, especially at areas that have remained important and sometimes controversial in the new era: reasons for credit use in the first place, usefulness and importance of access to credit, inclusion, competition, rate ceilings and their relation to credit availability and competition, small-dollar credit, unfair discrimination, disclosures, education, and interactions among supervisory agencies.

These are perennial issues and avoiding the wrong policy solutions or not paying proper attention to requirements that have become outmoded in these areas are matters requiring ongoing attention and consideration. This means that concerns of the NCCF remain important here, but this Taskforce Report does not overlook other newer issues. Many of the latter involve regulation of technological change, innovation, privacy, and education. These issues promise to become perennial as well and all of these matters probably will again be subjects for review by some future Commission or Taskforce more decades into the future. As noted above and discussed further in Chapter 2, the Taskforce report offers an overall look at consumer finance and consumer finance law at the end of the second half century of modern consumer credit, as the Report of the National Commission on Consumer Finance did after the first half century.

1.3 Scope of the Taskforce Report

While this report discusses a variety of aspects of consumer financial services, including shared concerns of technology, innovation, privacy, and developments in deposit and payments services, much of this report necessarily looks at consumer credit. For this reason, it is appropriate to define the consumer credit that is the subject of much the report and to say something at the outset about its importance. With this in mind, it is useful to summarize in more detail the scope and structure of the report that follows. Volume I examines the context of consumer finance and its regulation today, and Volume II looks more specifically at recommendations of the Taskforce.

Concerning context of the credit involved in much of the following discussion, we adopt the Federal Reserve Board's widely used definition of consumer credit in its monthly statistical release "Consumer Credit" as "credit extended to individuals, excluding loans secured by real estate." As outlined further in this monthly statistical release, this includes credit provided by depository institutions with banking charters, finance companies (including large auto lenders but also "payday" and other nonbank loan companies), credit unions, federal government (student loans), nonprofit and educational institutions, nonfinancial businesses (primarily retail stores and dealers), and holders of securitized assets. Consumer credit holdings of these institutions consist of both revolving credit and nonrevolving credit. Student loans, motor-vehicle loans, and credit cards fall within this definition, but not the huge mortgage-lending sector. Real-estate lending is certainly worth study and many academic and government agency studies have done so, but this area of modern finance is mostly not the subject at hand, except for its shared elements involving such matters as innovation, technology, privacy, and disclosures.

The consumer-credit sector of finance is immense on its own. From a base of about $6.8 billion at the end of 1945 and its wartime restrictions for anti-inflationary purposes (Regulation W), domestic consumer credit outstanding grew to more than $100 billion at the time of the NCCF and to more than $4 trillion at the end of 2019. Big numbers are not necessarily indicative of big problems, but there can be no question that the amount of outstanding domestic consumer credit today is massive in dollar terms. The subsequent chapter discusses expansion and distribution of consumer credit. This is enough subject matter for a report to be constructed within one year, and so mortgage credit that involves many questions about underlying housing assets, real estate development, zoning issues, real estate investment trusts (REITs), taxation, and other specialized matters of housing-related finance remains largely outside the focus area. Even where consumer credit is concerned, the focus here is on financial services laws, economics, and regulation rather than on operating questions or management.

Chapter 2 begins the core of the Taskforce's examination of consumer credit with a brief historical review of credit use by consumers and its regulation. This chapter then turns to examination of the subject of corresponding chapter in the NCCF's Report, growth and distribution of consumer credit within the population. This section of Chapter 2 examines long-term growth of consumer credit use to shed some light on inclusion and on the question often asked whether consumer credit has grown too much for too long. It then reviews survey evidence on who uses consumer credit.

Chapter 3 explores the demand side of the consumer financial market, the reasons why consumers use credit.[6] This discussion examines the reasoning of neoclassical economics and also newer theories associated with the term "behavioral economics." This chapter continues discussion of empirical findings from the previous chapter about how consumers use consumer credit. This leads to examination of rationales for regulation found later in Chapter 6. Government policies are often helpful, but should also be responsive to both important policy tradeoffs and risks of unintended consequences. Excessive regulation can also be costly or restrictive.

Chapter 4 examines the supply side of consumer financial markets, focusing on production costs for credit. Production costs are an important part of consumer lending and require a closer look. Costs that are too high for regulated prices also receive examination here and again in Chapter 5. This possibility advances the phenomenon of credit rationing.

Chapter 5 examines small-dollar credit and modern institutions that provide small-dollar credit. It explores provinces where credit rationing, controversy, and challenges regulating it are likely to occur. How to provide small amounts of credit at low prices has been problematic through recorded history, and the present is no exception.

This chapter also discusses what the Taskforce report characterizes as a normative issue. This is the concern whether any advisory commission or Taskforce can successfully make recommendations concerning access to small-dollar credit by those who use it. The difficulties and policy tradeoffs in this area suggest that no study or advisory group can easily answer all questions in this area in a way that is satisfactory to everyone. For instance, a study cannot suggest repeal of how generating such credit is costly relative to the loan size or how a substantial share of the observers of this lending are unhappy with the resulting higher interest rates. Any recommendations in this area go beyond the realms of law or economics and reach to philosophical questions of the role of government in a free society and how to reduce the problems of poverty after millennia of its existence. The Taskforce is not sanguine about this discussion, as the NCCF was not. The Taskforce again discusses the economics and issues of small-dollar lending but leaves the philosophical concerns surrounding the role of government in society or how to eradicate poverty to other contexts.

Chapter 6 focuses upon the conceptual underpinnings for undertaking economic regulation. After briefly examining underlying potential reasons for regulating and the intellectual history of

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[6] Later in this report, the Taskforce also variously discusses "consumer finance" more broadly to include also other consumer financial products, including consumer payments that do not involve extensions of credit.

economic regulation, this chapter looks at aspects of historical experience with consumer protection in the financial area. Regulatory areas and tools for consumer credit are discussed, and specific regulatory areas are enumerated. Necessarily, this chapter must circle back to the begged question, whether the whole of the current overlapping regulatory edifice is really needed, now a century into its construction. As with consumers' demand for credit where there can be overextensions, there also can be overextensions of regulation that produce unintended consequences. This is discussed here and later in Chapter 13.

Chapter 7 looks at disclosure as a consumer protection and how it might enhance or make simpler other sorts of protection. At a minimum, questions of consumer choice and the accompanying need for information can involve disclosures. Certainly, disclosure of relevant information also is important for making consumer-credit markets more competitive, which the NCCF discussed at considerable length in 1972. Need for information produced a whole new branch of economics in the 1960s (the Economics of Information), and it became an intellectual underpinning of the first federal foray into consumer protection regulation in the credit area: the Truth in Lending Act of 1968, intended as a disclosure law when passed.[7] This chapter also looks at what can go wrong with a disclosure regime.

Chapter 8 then focuses on competition more generally, the main underlying theme of the NCCF in 1972. This chapter examines in more detail the economic theories of competition, what competition can do for consumers as they use consumer credit and other financial services, and how competition interacts with regulation in markets today.

Chapter 9 examines innovation. Not only does innovation generate new products and new ways of doing things, but it also generates new divisions. Some observers embrace modernism and change as the hallmark of progress and advancement. Others emphasize the inability or slowness of some market participants to adapt to change, requiring control of the pace of change. Some fear that change will make things worse or less regulated. Pretty quickly, this leads to debate over the need for, or needed change in, regulatory regimes themselves. This chapter reviews new manifestations of this phenomenon for consumer financial services. The chapter looks in some detail at regulatory concerns over FinTechs, open banking, alternative data, regulatory sandboxes, and other current issues.

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[7]Federal controls on consumer credit during World War II, the late 1940s, and during the Korean War (Regulation W) were for economic stabilization and inflation-prevention purposes and not for consumer protection. For evaluation of the impact of Regulation W, see Board of GOVERNORS OF THE FEDERAL RESERVE SYSTEM, CONSUMER INSTALMENT CREDIT (six volumes, 1957).

Chapter 10 focuses more precisely on inclusion. Inclusion as a regulatory matter extends at least to the efforts of the Russell Sage Foundation in the 1910s but also importantly to hearings on discrimination that the NCCF held in 1970-72. These hearings led directly to the Equal Credit Opportunity Act (1974 and 1976). More recently, regulation also impacts market incentives for using technology to advance inclusion. Such incentives have led to development of statistical credit scoring and automated credit-reporting agencies (CRAs, popularly known as "credit bureaus"). Both were designed to improve inclusion by reducing production costs. Questions now also involve potential impact of using new kinds of nontraditional data for improving inclusion and how regulation might affect this area.

Chapter 11 focuses on another new area of concern as technology has unfolded: implications for privacy and the potential for system failure. Privacy concerns arise not only from data breaches, but also from uses of personal data found by some observers to be inappropriate. Recently, the beginnings of large-scale regulation in this area advanced at the state level raise questions of a new set of regulatory inconsistencies across jurisdictions.

Chapter 12 examines various issues on consumer empowerment. This chapter looks first at financial literacy and education. These were areas of concern to the National Commission on Consumer Finance in 1972, and remain important matters today. This chapter also examines issues of household savings, especially retirement savings, and the special challenges and opportunities facing younger consumers today with respect to financial products.

Finally, Chapter 13 reviews issues of the regulatory structure today and whether there are jurisdictional challenges that can be mitigated. New laws and institutions have emerged and evolved over the past several decades in a piecemeal fashion. We focus on areas of regulatory redundancy and incompatibility, as well as lacunae or oversights in the consumer financial regulatory system, both on the federal level and with respect to state authority. This chapter discusses such issues and how appropriate Memoranda of Understanding (MOUs) carefully outlining joint operations and territories in some cases might well benefit everyone.

Overall, these chapters renew and vitalize the work begun by the NCCF in examining the progress of domestic consumer financial matters and their institutions. The NCCF examined the first 50 years of modern consumer credit, from the reforms of the Russel Sage Foundation to the dawn of its federal regulation. The next 50 years have witnessed growth in access to financial services, further growth in public acceptance of consumer credit and other financial services, advances in technology, and ongoing regulation. It is worth stepping back and looking at the underpinnings and current development of these important and widespread phenomena again.

CHAPTER 1, APPENDIX A:

Review of the Report and Recommendations of the National Commission on Consumer Finance in 1972

The NCCF's Congressional charge is in paragraph 404 of Title IV of the Consumer Credit Protection Act (Public Law 90-321, May 29, 1968):

(a) The Commission shall study and appraise the functioning and structure of the consumer finance industry, as well as consumer credit transactions, generally. The Commission, in its report and recommendations to the Congress, shall include treatment of the following topics:

(1) The adequacy of existing arrangements to provide consumer credit at reasonable rates.

(2) The adequacy of existing supervisory and regulatory mechanisms to protect the public from unfair practices and inspire the informed use of consumer credit.

(3) The desirability of federal chartering of finance companies, or other federal regulatory measures.

(b) The Commission may make interim reports and shall make a final report of its findings, recommendations, and conclusions to the President and to Congress by January 1, 1971. [Note: Due to delays in appointing members of the Commission and for other reasons, Congress subsequently changed the date to December 31, 1972.]

Title IV specified that Commission members were to be three designees from the House of Representatives, three members of the Senate, and three public members appointed by the President, one of whom was to be chairman. This made the Commission bipartisan but not nonpartisan. The longest section of Title IV was paragraph 405, concerning subpoena powers and other aspects of the Commission's operations that are not relevant today.

The Commission's Report consisted of 12 chapters and measured 294 pages. There were forward and appendix sections containing summary of recommendations, separate statements of Commission members (in part reflective of differing political views), summary of hearings, a list of studies, and extensive footnotes. After publication of its Report (and after some delays at the Government Printing Office), the NCCF also published six volumes of its technical studies. The recommendations themselves were embedded within the relevant chapters of the Report where the reasoning supporting each of them individually resided, as well as listed together in a forward section. The chapters were:

1. An Overview of the Study and Some Conclusions
2. Development and Structure of Consumer Credit
3. Creditors' Remedies and Contract Provisions
4. Supervisory Mechanisms
5. Credit Insurance
6. Rate Ceilings
7. Rates and Availability of Credit
8. Special Problems of Availability
9. Federal Chartering
10. Disclosure
11. Education
12. The Future of Consumer Credit

Overall, a careful reading of the NCCF Report reveals six main themes (combined and summarized into five earlier) that run through its entirety and its recommendations (a complete listing of the NCCF's specific recommendations is at the end of this appendix, and its membership, staff, and studies are in Appendix B to this chapter):

1. Emphasizing the importance of institutional competition as a main bulwark of consumer protection, focusing on the need to remove and/or prevent any existing and future barriers to entry to support this goal.

2. Rethinking the role of legislated or regulatory interest-rate ceilings. In the view of the Commission, they were a barrier to entry that not only interfered with competition, but also

made many situations of credit availability worse, sometimes even leading to credit unavailability.

3. Including everyone in fair consumer credit markets.

4. Eliminating excesses in consumer credit markets associated with archaic collection methods and practices.

5. Continuing improvement in the flows of information to consumers about their financial transactions.

6. Ensuring adequate supervision and enforcement where currently insufficient.

These themes are quite visible early in the Report, even forming the bulk of the transmittal letter from the NCCF Chairman Ira M. Millstein to the President and Congress (p. iii):

As to the Report itself, I believe the Commission was unanimous in concluding that a truly competitive consumer credit market, with adequate disclosure of relevant facts to an informed consuming public, together with legislation and regulation to eliminate excesses, will foster economic growth and serve to optimize benefits to the consumer.

As to excesses in the marketplace, our Report recommends significant additions to the protection of consumers in the fields of creditors' remedies and collection practices. We have urged restrictions on remedies such as garnishment, repossession, and wage assignment. We have recommended abolition of the holder in due course doctrine, confessions of judgment, and harassing tactics in debt collections.

As to adequate disclosure of relevant facts, our Report urges enhanced supervision and enforcement of the Federal Truth in Lending Act. We have also specified actions to make the disclosure features of Truth in Lending more effective and have suggested expanding the coverage of that Act to include disclosure of charges for credit life and accident and health insurance as an annual percentage rate.

We also favored making federally chartered financial institutions subject to state as well as federal examination for compliance with state laws governing the terms and conditions of consumer credit extensions. In addition, we recommended expanded administrative authority over all classes of creditors.

As to our conclusion that free and fair competition is the ultimate and most effective protector of consumers, we have recommended the elimination of restrictive barriers to entry in consumer credit markets by permitting all creditors open access to all areas of consumer credit. We have urged the entry of savings and loan associations and mutual savings banks into the consumer credit market. We have recommended prohibitions on acquisitions that would eliminate potential competition or that would substantially increase concentration in state or local credit markets. We have also urged that rate ceilings, which constrain the development of workably competitive markets be reviewed by those states seeking to increase credit availability at reasonable rates.

Some of these areas, notably including some of the most controversial at the time, seem settled or even a bit archaic today, almost 50 years later. For instance, allowable creditors' remedies, a controversial area then and discussed in one of the longest chapters in the NCCF's Report (Chapter 3), have changed considerably since the NCCF's time. In the intervening years, federal and state actions have eliminated many private actions such as confessions of judgement that were permissible in the past. Many of the specific creditors' remedies discussed by the NCCF are more of historical interest today than current concerns.

Further, one of the central themes through the Commission's Report in 1972 seems agreed upon today: the need for promoting competition in consumer credit markets by preventing barriers to entry. There is ongoing need for government to encourage competition among service providers, but many of the Commission's recommendations for removal of legislative and regulatory barriers to entry like licensing requirements designed to restrict entry have been implemented in the intervening years.

The NCCF also argued for maintaining large numbers of individually competing firms by antitrust action to prevent mergers that would increase market concentration in a smaller number of firms. This specific need today is a matter of debate in antitrust law concerning financial services, but many other intervening institutional changes have meanwhile contributed importantly to increased competition. They include many of the technological advances in data processing, storage, and analysis that have taken place since the NCCF's time.

Technological change has permitted wider geographic spheres for competing institutions. For instance, today worldwide credit card operations of distant banking entities and instant acceptance of financial products like credit cards globally have pushed credit competition far beyond localized markets prevalent in the past. Today, many financial institutions compete at least nationally. Technology has also permitted availability of comprehensive credit-bureau histories and credit-bureau risk scores to any potential lender at low cost, eliminating barriers to entry in the information area.

Another somewhat archaic area involves credit insurance, where the main question for the NCCF was competitiveness of markets for the product (Chapter 5 of the NCCF Report). This product is still around today, but it can be considered to a degree a niche product now, and it is subject to price ceilings and regulated by insurance or financial-institutions regulatory departments in all the states.

An area that has not settled down is supervisory mechanisms (Chapter 4 of the NCCF Report), despite many changes. States generally had departments of banking or financial institutions and sometimes consumer affairs in the NCCF era, but structures, responsibilities, authority, and resources of the state agencies varied widely. There were inconsistencies both across states and, often, the relevant supervisory bodies within a state. Consumer credit regulation was mostly not a domain of federal activity then, with Truth in Lending and bankruptcy law the exceptions, the latter specifically enumerated as a federal responsibility in the 1789 Constitution. Now there are professional agencies or departments responsible for consumer affairs within the financial regulatory structures of all the states and in the federal government.

At the time of the NCCF, the focus of the federal financial regulatory agencies was almost solely on institutional safety and soundness of those under their charge. Today, these agencies also have departments of consumer affairs and relevant examination and enforcement staff in this area. Further, the Federal Trade Commission retains its long-standing Bureau of Consumer Protection, and in 2010, Congress instituted the Consumer Financial Protection Bureau. This agency has responsibility today over 18 major pieces of federal legislation, only one of which was in effect at the time when the NCCF prepared its Report (Truth in Lending). And so, further federal supervision that was still a question at the time of the NCCF is now well evident.

All these agencies and departments operating in essentially the same area today, however, raise substantial questions, beginning with federalism and coordination of responsibilities across levels of government. Issues involve interaction between federal legislation and agencies with similar responsibilities at the state level but also coordination among federal agencies themselves. Today, there are questions of jurisdiction, overlap, and efficiency of the entire system built over the decades since the NCCF Report.

Concerns like federal chartering of finance companies and other entities (Chapter 9 of the NCCF Report) have gone and returned over the decades. As indicated, until 1968 the federal government had relatively little presence in consumer financial regulation, but this has changed without instituting new federal chartering. The question of federal chartering has come back again recently, with discussion whether there should be federal chartering and regulation of companies that might want to provide credit and other consumer financial services using new technologies, known typically today as "FinTechs."

Among the most controversial sections of the NCCF Report in 1972, and the parts containing a substantial part of the NCCF's unfinished business today, are the chapters right in the middle of the Report: "Rate Ceilings" (Chapter 6), "Rates and Availability of Credit" (Chapter 7), and "Special Problems of Availability" (Chapter 8). All these chapters involved interest-rate ceilings that were prevalent at the time and their impact. Chapter 8 also reviewed some other interrelated questions concerning unfair discrimination and credit availability.

Rate ceilings on credit use have been controversial for centuries, and the NCCF paid them central attention. The regimes of state rate ceilings in place at the time changed soon afterward, clearly not due solely to the NCCF. Rapid changes in rate-ceiling laws at the time undoubtedly owed some intellectual debt to the NCCF Report, but the driving forces were the extremely high interest-rate periods of the late 1970s and early 1980s that caused many economic disruptions at the time. They included upheavals in housing markets where ceilings interfered with both home sales and housing construction.

By the early 1980s, federal legislation that was part of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), had removed commercial and housing credit from state rate regulation. At the same time or shortly afterward, many states also altered their rate regulations on consumer credit, often raising or eliminating ceilings on various kinds of credit within their jurisdictions. Court decisions around the same time enabled national banks located in states with less restrictive rate ceilings to charge their home-state rates on credit extended to borrowers located in other, more restrictive states.

After the extreme interest rates worldwide subsided a bit by the middle and later 1980s, alterations of legislated ceilings continued. Since then, many states have further changed their rate regulations, raising ceilings in some cases, reducing ceilings elsewhere, or adapting them to new institutions. More recent changes have mostly involved small-dollar lenders such as so-called "payday lenders," where some states have specifically allowed them, and others specifically prohibited them. At the federal level, Congress adopted the Military Lending Act in 2006 establishing federal rate ceilings on some kinds of consumer credit for military families. Since then, there has been discussion of extending the federal rate ceilings in the Military Lending Act to civilian consumer credit.

Chapter 6 of the NCCF Report provided general background on rates and rate ceilings, and Chapter 7 looked more closely at new empirical evidence about them, much of it based upon the NCCF's data-gathering efforts. Besides continuing this discussion, Chapter 8 looked at other special questions involving credit availability, notably including credit discrimination considered unfair.

Credit discrimination was not part of federal regulatory activity at the time the NCCF delivered its Report in December 1972. Congress passed the Equal Credit Opportunity Act later in 1974 and extensively revised it afterward in 1976. Nonetheless, the Commission held a set of public hearings on this issue and considered this area at considerable length in Chapter 8 of its Report. Eliminating unfair credit discrimination itself has not generally been controversial since passage of the Equal Credit Opportunity Act in 1974 and its extensive amendment in 1976, but the precise regulatory definition of illegal discrimination has been subject of concerns and remains so.

One other key area studied by the NCCF has also remained controversial: disclosures (Chapter 10 of the NCCF Report). Most observers favor relevant disclosures on financial transactions, but the questions always have surrounded the proper extent of relevant disclosures for what purposes and when.

At the time of the NCCF, Truth in Lending was still the only significant area of federal government presence in consumer credit regulation (other than bankruptcy that is a federal responsibility according to the Constitution), and not surprisingly, the NCCF discussed disclosures at some length. The NCCF also sponsored original research projects in this area, which it reviewed in its Report.

Since that time, additional disclosures have been an element of every further federal legislative effort in the consumer credit area including fair credit reporting, equal credit opportunity, bankruptcy reform, privacy, and electronic funds transfers. Further, the Truth in Lending Act has been amended many times over its five decades, and it has seemed like its implementing rules (Regulation Z and its Official Commentary) have been in almost constant flux. Continued reliance on disclosures as consumer protections means that concern whether disclosures are "effective" or not has never disappeared.

In many ways, consumer education is closely related to disclosures, and the NCCF addressed it in Chapter 11 before its conclusory observations about the future of consumer credit in Chapter 12. Since new consumers develop every year with population growth and the passage of time, this issue never gets old, and the Taskforce discusses it again in its own Chapter 12 before its concluding look at regulatory jurisdiction in its Chapter 13.

The following is a full listing of the recommendations of the NCCF in its 1972 Report:

A Full Listing of the Recommendations of the National Commission on Consumer Finance enumerated in its Report to the President and Congress in December 1972

Contract Provisions and Creditors' Remedies (Chapter 3)

Contract Provisions

Acceleration Clauses – Default - Cure of Default

Acceleration of the maturity of all or any part of the amount owing in a consumer credit transaction should not be permitted unless a default as specified in the contract or agreement has occurred.

A creditor should not be able to accelerate the maturity of a consumer credit obligation, commence any action, or demand or take possession of any collateral, unless the debtor is in default, and then only after he has given 14 days prior written notice to the debtor of the alleged default of the amount of the delinquency (including late charges), of any performance in addition to payment required to cure the default and of the debtor's right to cure the default.

Under such circumstances, for 14 days after notice has been mailed, a debtor should have the right to cure a default arising under a consumer credit obligation by:

1. Tendering the amount of all unpaid instalments due at the time of tender, without acceleration, plus any unpaid delinquency charges; and by

2. Tendering any performance necessary to cure a default other than nonpayment of accounts due.

However, a debtor should be able to cure no more than three defaults during the term of the contract. After curing default, the debtor should be restored to all his rights under the consumer credit obligation as though no default had occurred.

Attorney's Fees

Consumer credit contracts or agreements should be able to provide for payment of reasonable attorney's fees by the debtor in the event of default if such fees result from referral to an attorney who is not a salaried employee of the creditor; in no event should such fees exceed 15 percent of the outstanding balance. However, this agreement should further stipulate that in the event suit is initiated by the creditor and a court finds in favor of the consumer, the creditor should be liable for the payment of the debtor's attorney's fees as determined by the court, measured by the amount of time reasonably expended by the consumer's attorney and not by the amount of the recovery.

Confessions of Judgment - Cognovit Notes

No consumer credit transaction contract should be permitted to contain a provision whereby the debtor authorizes any person, by warrant of attorney or otherwise, to confess judgment on a claim arising out of the consumer credit transaction without adequate prior notice to the debtor and without an opportunity for the debtor to enter a defense.

Cross-Collateral

In a consumer credit sale, the creditor should not be allowed to take a security interest in goods or property of the debtor other than the goods or property which are the subject of the sale. In the case of "add-on" sales, where the agreement provides for the amount financed and finance charges resulting from additional sales to be added to an existing outstanding balance, the creditor should be able to retain his security interest in goods previously sold to the debtor until he has received payments equal to the sales price of the goods (including finance charges). For items purchased on different dates, the first purchased should be deemed the first paid for; and for items purchased on the same date, the lowest priced items should be deemed the first paid for.

Household Goods

A creditor should not be allowed to take other than a purchase money security interest in household goods.

Security Interest – Repossession - Deficiency Judgments

A seller-creditor should have the right to repossess goods in which a security interest exists upon default of contract obligations by the purchaser-debtor. At the time the creditor sends notice of the cure period (14 days), and prior to actual repossession (whether by replevin with the aid of state officers or by self-help), the creditor may simultaneously send notice of the underlying claim against the debtor and the debtor should be afforded an opportunity to be heard in court on the merits of such claim. The time period for an opportunity to be heard may run concurrently with the cure period.

Where default occurs on a secured credit sale in which the original sales price was $1,765 or less, or on a loan in which the original amount financed was $1,765 or less and the creditor took a security interest in goods purchased with the proceeds of such loan or in other collateral to secure the loan, the creditor should be required to elect remedies: either to repossess collateral in full satisfaction of the debt without the right to seek a deficiency judgment, or to sue for a personal judgment on the obligation without recourse to the collateral, but not both.

Wage Assignments

In consumer credit transactions involving an amount financed exceeding $300, a creditor should not be permitted to take from the debtor any assignment, order for payment, or deduction of any salary, wages, commissions, or other compensation for services or any part thereof earned or to be earned. In consumer credit transactions involving an amount financed of $300 or less, where the creditor does not take a security interest in any property of the debtor, the creditor should be permitted to take a wage assignment but in an amount not to exceed the lesser of 25 percent of the debtor's disposable earnings for any workweek or the amount by which his disposable earnings for the workweek exceeds 40 times the federal minimum hourly wage prescribed by section 6(a) (I) of the Fair Labor Standards Act of 1938 in effect at the time.

Creditors' Remedies

Body Attachment

No creditor should be permitted to cause or permit a warrant to issue against the person of the debtor with respect to a claim arising from a consumer credit transaction. In addition, no court should be able to hold a debtor in contempt for failure to pay a debt arising from a consumer credit transaction until the debtor has had an actual hearing to determine his ability to pay the debt.

Garnishment

Prejudgment garnishment, even of nonresident debtors, should be abolished. After entry of judgment against the debtor on a claim arising out of a consumer credit transaction, the maximum disposable earnings of a debtor subject to garnishment should not exceed the lesser of:

1. 25 percent of his disposable earnings for the workweek, or

2. The amount by which his disposable earnings for the workweek exceeds 40 times the federal minimum hourly wage prescribed by section 6(a) (!)of the Fair Labor Standards Act of 1938, in effect at the time the earnings are payable. (In the event of earnings payable for a period greater than a week, an appropriate multiple of the federal minimum hourly wage would be applicable.)

A debtor should be afforded an opportunity to be heard and to introduce evidence that the amount of salary authorized to be garnished would cause undue hardship to him and/or his family. In the event undue hardship is proved to the satisfaction of the court, the amount of the garnishment should be reduced or the garnishment removed.

No employer should be permitted to discharge or suspend an employee solely because of any number of garnishments or attempted garnishments by the employee's creditors.

Holder in Due Course Doctrine-Waiver of Defense Clauses-Connected Loans

Notes executed in connection with consumer credit transactions should not be "negotiable instruments;" that is, any holder of such a note should be subject to all the claims and defenses of the maker (the consumer-debtor). However, the holder's liability should not exceed the original amount financed. Each such note should be required to have the legend "Consumer Note - Not Negotiable" clearly and conspicuously printed on its face.

Holders of contracts and other evidences of debts which are executed in connection with consumer credit transactions other than notes should similarly be subject to all claims and defenses of the consumer-debtor arising out of the transaction, notwithstanding any agreement to the contrary. However, the holder's liability should not exceed the original amount financed.

A creditor in a consumer loan transaction should be subject to all of the claims and defenses of the borrower arising from the purchase of goods or services purchased with the proceeds of the loan, if the borrower was referred or otherwise directed to the lender by the vendor of those goods or services and the lender extended the credit pursuant to a continuing business relationship with the vendor. In such cases, the lender's liability should not exceed the lesser of the amount financed or the sales price of the goods or services purchased with the proceeds of the loan.

Levy on Personal Property

Prior to entry of judgment against a debtor arising out of a consumer credit transaction, while a court may create a lien on the personal property of the debtor, that lien should not operate to take or divest the debtor of possession of the property until final judgment is entered. However, if the court should find that the creditor will probably recover in the action, and that the debtor is acting or is about to act in a manner which will impair the creditor's right to satisfy the judgment out of goods upon which a lien has been established, the court should have authority to issue an order restraining the debtor from so acting. The following property of a consumer debtor should be exempt from levy, execution, sale, and other similar process to satisfy judgment arising from a consumer credit transaction (except to satisfy a purchase money security interest created in connection with the acquisition of such property).

1. A homestead to the fair market value of $5,000 including a house, mobile home, or like dwelling, and the land it occupies if regularly occupied by the debtor and/or his family as a dwelling place or residence and intended as such.

2. Clothing and other wearing apparel of the debtor, spouse, and dependents to the extent of $350 each.

3. Furniture, furnishings, and fixtures ordinarily and generally used for family purposes in the residence of the debtor to the extent of the fair market value of $2,500.

4. Books, pictures, toys for children and other such kinds of personal property to the extent of $500.

5. All medical health equipment being used for health purposes by the debtor, spouse, and dependents.

6. Tools of trade, including any income-producing property used in the principal occupation of the debtor, not to exceed the fair market value of $1,000.

7. Any policy of life or endowment insurance which is payable to the spouse or children of the insured, or to a trustee for the benefit of the spouse or children of the insured, except the cash value or any accrued dividends thereof.

8. Burial plots belonging to the debtor and/or spouse or purchased for the benefit of minor children to the total value of $1,000.

9. Other property which the court may deem necessary for the maintenance of a moderate standard of living for the debtor, spouse, and dependents.

Contacting Third Parties

No creditor or agent or attorney of a creditor before judgment should be permitted to communicate the existence of an alleged debt to a person other than the alleged debtor, the attorney of the debtor, or the spouse of the debtor without the debtor's written consent.

Miscellaneous Recommendations

BALLOON PAYMENT

With respect to a consumer credit transaction, other than one primarily for an agricultural purpose or one pursuant to open end credit, if any scheduled payment is more than twice as large as the average of earlier scheduled payments, the consumer should have the right to refinance the amount of that payment at the time it is due without penalty. The terms of the refinancing should be no less favorable to the consumer than the terms of the original transaction. These provisions do not apply to a payment schedule which, by agreement, is adjusted to the seasonal or irregular income of the consumer.

COSIGNER AGREEMENTS

No person other than the spouse of the principal obligor on a consumer credit obligation should be liable as surety, cosigner, comaker, endorser, guarantor, or otherwise assume personal liability for its payment unless that person, in addition to signing the note, contract, or other evidence of debt also signs and receives a copy of a separate cosigner agreement which explains the obligations of a cosigner.

REBATES FOR PREPAYMENT

A consumer should always be allowed to prepay in full the unpaid balance of any consumer credit obligational any time without penalty. In such instances, the consumer should receive a rebate of the unearned portion of the finance charge computed in accordance with the "balance of the digits" (otherwise known as "sum of the digits" or "rule of 78's" method) or the actuarial method. For purpose of determining the instalment date nearest the date of prepayment, any prepayment of an obligation payable in monthly instalments made on or before the 15th day following an instalment due date should be deemed to have been made as of the instalment due date, and if prepayment occurs on or after the 16th it should be deemed to have been made on the succeeding instalment due date. If the total of all rebates due to the consumer is less than $1 no rebate should be required.

In the event of prepayment, the creditor should not be precluded from collecting or retaining delinquency charges on payments due prior to prepayment.

In the case of credit for defective goods, the consumer should be entitled to the same rebate as if payment in full had been made on the date the defect was reported to the creditor or merchant.

If the maturity of a consumer credit obligation is accelerated as a result of default, and judgment is obtained or a sale of secured property occurs, the consumer should be entitled to the same rebate that would have been payable if payment in full had been made on the date judgment was entered or the sale occurred.

Upon prepayment in full of a consumer credit obligation by the proceeds of credit insurance, the consumer or his estate should be entitled to receive the same rebate that would have been payable if the consumer had prepaid the obligation computed as of the date satisfactory proof of loss is furnished to the company.

Unfair Collection Practices

HARASSMENT

No creditor, agent or attorney of the creditor, or independent collector should be permitted to harass any person in connection with the collection or attempted collection of any debt alleged to be owing by that person or any other person.

SEWER SERVICE

If a debtor has not received proper notice of the claim against him and does not appear to defend against the claim, any judgment entered shall be voided and the claim reopened upon the debtor's motion.

INCONVENIENT VENUE

No creditor or holder of a consumer credit note or other evidence of debt should be permitted to commence any legal action in a location other than (1) where the contract or note was signed, (2) where the debtor resides at the commencement of the action, (3) where the debtor resided at the time the note or contract was made, or (4) if there are fixtures, where the goods are affixed to real property.

CONSUMER CREDIT AND CONSUMER INSOLVENCY

Chapter XIII of the Bankruptcy Act should be expanded as endorsed by the House of Delegates of the American Bar Association in July 1971 to permit Chapter XIII courts, under certain circumstances, to alter or modify the rights of secured creditors when they find that the plan adequately protects the value of the collateral of the secured creditor.

In petitions for relief in bankruptcy, the bankruptcy court should disallow claims of creditors stemming from "unconscionable" transactions.

Bankruptcy courts should provide additional staff to serve as counselors to debtors regarding their relations with creditors, and their personal, credit, and domestic problems.

DOOR-TO-DOOR SALES

In any contract for the sale of goods entered into outside the creditor's place of business and payable in more than four installments, the debtor should be able to cancel the transaction at any time prior to midnight of the third business day following the sale.

ASSESSMENT OF DAMAGES

If a creditor in a consumer credit transaction obtains a judgment by default, before a specific sum is assessed the court should hold a hearing to establish the amount of the debt the creditor-plaintiff is lawfully entitled to recover.

Supervisory Mechanisms (Chapter 4)

The Commission recommends that:

Legislatures and administrators in states with less than 2-1/2 man-days available per year per small loan office reassess their staffing capabilities with the goal of improving their ability to fulfill the examination responsibility prescribed by law.

All federal regulatory agencies adopt and enforce uniform standards of Truth in Lending examination.

Congress create within the proposed Consumer Protection Agency· a unit to be known as the Bureau of Consumer Credit (BCC) with full statutory authority to issue rules and regulations and supervise all examination and enforcement functions under the Consumer Credit Protection Act, including Truth in Lending; an independent Consumer Credit Agency be created in the event that the proposed Consumer Protection Agency is not established by Congress; the independent agency would have the same functions and authorities recommended for the Bureau of Consumer Credit.

Agencies supervising federally chartered institutions undertake systematic enforcement of federal credit protection laws like Truth in Lending.

Federal law be expressly changed to authorize state officials to examine federally chartered institutions for the limited purpose of enforcing state consumer laws, but such authorization should in no way empower state officials to examine federally chartered institutions for soundness, fraudulent practices, or the like; the limited state examinations should be required by law to be performed in a manner that would not disrupt or harass the federally chartered institutions.

State consumer credit laws be amended to bring second mortgage lenders and any other consumer lenders under the same degree of administrative control imposed on licensed lenders.

Congress consider whether to empower state officials to enforce Truth in Lending and garnishment restrictions of the Consumer Credit Protection Act and any similar laws that may be enacted.

State laws covering retailers and their assignees be amended, where necessary, to give authority to a state administrative agency to enforce consumer credit laws against all sellers who extend consumer credit; but administrative regulation need not and should not entail either licensing or limitations on market access.

States which do not subject sales finance companies to enforcement of consumer credit laws amend their laws to bring such companies under enforcement; such authority need not and should not entail licensing or limitations on market access.

State laws be amended to give a state administrative agency authority to enforce consumer credit laws against all credit grantors - deposit holding institutions, nondeposit holding lenders, and retailers and their assignees. This authority should include the right to enter places of business, to examine books and records, to subpoena witnesses and records, to issue cease and desist orders to halt violations, and to enjoin unconscionable conduct in making or enforcing unconscionable contracts. The agency should be able to enforce the right of consumers, as individuals or groups, to refunds or credits owing to them under appropriate statutes.

Legal services programs - legal aid, neighborhood legal services, rural legal assistance, public defender - continue to receive federal, state, and local government support.

Consumer protection laws be amended, where necessary, to assure payment of legal fees incurred by aggrieved private consumers and provide them with remedies they can enforce against creditors who violate these laws.

The proposed BCC be authorized to establish a National Institute of Consumer Credit to function as the BCC's research arm.

The BCC, acting through the National Institute of Consumer Credit, be empowered to cooperate with and offer technical assistance to states in matters relating to consumer credit protection-examinations, enforcement, and supervision of consumer credit protection laws.

The BCC be authorized:

to require state and federal agencies engaged in supervising institutions which grant consumer credit to submit such written reports as the Bureau may prescribe;

to administer oaths;

1. to subpoena the attendance and testimony of witnesses and the production of all documentary evidence relating to the execution of its duties;

2. to intervene in corporate mergers and acquisitions where the effect would be to lessen competition in consumer credit markets, to include but not be limited to applications for new charters, offices, and branches;

3. to invoke the aid of any district court of the United States in requiring compliance in the case of disobedience to a subpoena or order issued;

4. to order testimony to be taken by deposition before any person designated by the Bureau with the power to administer oaths, and in such instances to compel testimony and the production of evidence in the same manner as authorized under subparagraphs (3) and (5) above.

Credit Insurance (Chapter 5)

The Commission recommends that:

The finance charge earned by credit grantors should be sufficient to support the provision of the credit service. The finance charge should not subsidize the credit insurance service. Nor should the charge for credit insurance subsidize the credit operation.

The proposed Bureau of Consumer Credit in the Consumer Protection Agency make a study to determine acceptable forms of credit insurance and reasonable levels of charge and prepare recommendations.

The states should immediately review charges for credit insurance in their jurisdictions and lower rates where they are excessive.

Creditors offering credit life and accident and health insurance be required to disclose the charges for the insurance both in dollars and cents and as an annual percentage rate in the same manner as finance charges and annual percentage rates of finance charges are required to be disclosed under the Truth in Lending Act and Regulation Z.

Rates and Availability of Credit (Chapter 7)

Although the Commission makes no generally applicable recommendation concerning branch banking because conditions can vary among the states, it does recommend that where statewide branching is allowed, specific steps be taken to assure easy new entry and low concentration. Such steps would:

1. Give preferential treatment wherever possible to charter applications of newly forming banks as opposed to branch applications of dominant established banks.

2. Favor branching, especially de novo branching, whether directly or through the holding company device when such branching promotes competition. Banking regulators should exercise a high degree of caution in permitting statewide branching whether directly or through the holding company device when such branching decreases competition or increases economic concentration.

3. Encourage established banks and regulatory agencies to see that correspondent bank services be made available (for a reasonable fee) to assist newly entering independent banks, including the provision of loan participation agreements when needed.

4. Disallow regional expansion by means of merger and holding company acquisitions when such acquisitions impair competition, recognizing that statewide measures of competition are relevant.

The Commission recommends, as did the President's Commission on Financial Structure and Regulation, that under prescribed conditions savings and loan associations and mutual savings banks be allowed to make secured and unsecured consumer loans up to amounts not to aggregate in excess of 10 percent of total assets.

The Commission recommends that the only criterion for entry (license) in the finance company segment of the consumer credit market be good character, and that the right to market entry not be based on any minimum capital requirements or convenience and advantage regulations. The Commission recommends that direct bank entry in the relatively high risk segment of tlie personal loan market be made feasible by:

1. Permitting banks to make small loans under the rate structure permitted for finance companies;

2. Encouraging banks to establish de novo small loan offices as subsidiary or affiliated separate corporate entities. Regardless of corporate structure these small loan offices, whether corporate or within other bank offices, should be subject to the same examination and supervisory procedures that are applied to other licensed finance companies;

3. Exempting consumer loans from the current requirement that bank loan production offices obtain approval for each loan from the bank's main office; and

4. Prohibiting the acquisition of finance companies by banks when banks are permitted to establish de novo small loan offices. The Commission recommends that existing regulatory agencies disallow mergers or stock acquisitions among any financial institutions whenever the result is a substantial increase in concentration on state or local markets.

The Commission recommends that inter-institutional acquisitions be generally discouraged even though there is no effect on intra-institutional concentration.

The Commission recommends that state regulatory agencies and legislatures review the market organization of their respective financial industries after a 10-year trial period of earnest implementation of the recommendations on market entry and concentration. If, despite these procompetitive efforts, such a review discloses an inadequacy of competition-as indicated, say, by a continuing market dominance by a few commercial banks and finance companies or the absence of more frequent entry - then a restructuring of the industry by dissolution and divestiture world probably be appropriate and beneficial.

The Commission recommends that antitrust policy, both federal and state, be alert to restrictive arrangements in the credit industry. Any hint of agreement among lenders as to rates, discounts, territorial allocations and the like must be vigorously pursued and eliminated.

The Commission recommends that each state evaluate the competitiveness of its markets before considering raising or lowering rate ceilings from present levels. Policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed.

Discrimination (Chapter 8)

The Commission recommends that:

States undertake an immediate and thorough review of the degree to which their laws inhibit the granting of credit to creditworthy women and amend them, where necessary, to assure that credit is not restricted because of a person's sex.

Congress establish a pilot consumer loan fund and an experimental loan agency to determine whether families whose incomes are at or below the Federal Guideline for Poverty Income Levels issued annually by OEO have the ability to repay small amounts of money which they may need to borrow.

$1.5 million be appropriated for an experimental low income loan program to be allocated among operating expenses, loss write-offs, and loan extensions according to guidelines developed by an advisory committee to the Bureau of Consumer Credit.

There be continued experimentation by private industry in cooperation with federal, state, and local governments to provide credit to the poor.

Legislation permitting "small small" loans should be encouraged as a suitable means of providing loans to the poor from regulated, licensed lenders.

Federal Chartering (Chapter 9)

The Commission recommends that federal chartering of finance companies be held in abeyance for 4 years while two complimentary courses of action are pursued: (1) efforts should be undertaken to persuade the states to remove from existing laws and regulations anticompetitive (and by extension, anti-consumer) restrictions on entry and innovation and, (2) Congress should sustain the research initiated by the Commission.

If the substantive portions of the Commission's recommendations regarding workably competitive markets are not enacted within 4 years and states have not eliminated barriers to entry, the Commission recommends that Congress permit federal chartering of finance companies with powers to supersede state laws in three basic areas which sometimes severely limit competition in availability of credit: limitations on entry, unrealistic rate ceilings, and restraints on amounts and forms of financial services offered consumers.

Disclosure (Chapter 10)

The Commission recommends that:

The Board of Governors of the Federal Reserve System regularly publish a statistical series showing an average (and possibly a distribution) of annual percentage rates for at least three major types of closed end consumer instalment credit: new automobiles, mobile homes, and personal loans.

The Truth in Lending Act should be further amended to require creditors who do not separately identify the finance charge on credit transactions involving more than four instalments to state clearly and conspicuously in any advertisement offering credit: "THE COST OF CREDIT IS INCLUDED IN THE PRICE QUOTED FOR THE GOODS AND SERVICES."

The Truth in Lending Act be amended to make clear the presumption that all discounts or points, even when paid by the seller, are passed on to the buyer and hence must be included in the finance charge.

Section 106(e) of the Truth in Lending Act be amended to delete as excludable from the finance charge the following items numbered in accordance with that paragraph:

(5) Appraisal fees

(6) Credit reports

A full statement of all closing costs to be incurred be presented to a consumer prior to his making any downpayment. In any case, a full statement of closing costs should be provided at the time the lender offers a commitment on a consumer credit real property transaction or not later than a reasonable time prior to final closing.

Section 104(4) of the Truth in Lending Act which exempts public utility transactions from disclosure requirements be repealed. Creditors be required to disclose the charge for credit insurance both in dollars and as an annual percentage rate in the same manner as the finance charge is required to be disclosed. Additionally, where credit insurance is advertised, that the premium be required to be expressed as an annual percentage rate.

Exempted transactions (Section 104) of the Truth in Lending Act should include credit transactions primarily for agricultural purposes in which the total amount to be financed exceeds $25,000, irrespective of any security interest in real property.

Creditors offering open end credit be permitted to advertise only the periodic rate and the annual percentage rate;

Where terms other than rates are advertised, only the following terms be stated in the advertisement:

- Closed end credit
- The cash price or the amount of the loan as applicable.
- The number, amount, and due dates or period of payments scheduled to repay the indebtedness if the credit is extended.

- The annual percentage rate, or the dollar finance charge when the APR is not required on small transactions.
- Open end credit
- The minimum periodic payment required and the method of determining any larger required periodic payment.
- The method of determining the balance upon which a finance charge may be imposed.
- The periodic rate(s).
- The annual percentage rate(s).

Sections 143 and 144 of the Truth in Lending Act be amended to make clear that there may be no expression of a rate in an advertisement of closed end credit other than the annual percentage rate as defined in the Truth in Lending Act and regulation Z.

Legislation be adopted to permit private suits seeking injunctive relief to false or misleading advertising.

The Truth in Lending Act be amended to provide that the Act and regulation Z apply to oral disclosures.

State laws which are inconsistent with the Federal Truth in Lending Act or which require disclosures which might tend to confuse the consumer or contradict, obscure, or detract attention from the disclosures required by the Truth in Lending Act and regulation Z be preempted by the federal law.

The Truth in Lending Act be amended as necessary to assure that subsequent assignees are held equally liable with the original creditor when violations of the Truth in Lending Act are evident on the face of the agreement or disclosure statement; and that there be equal enforcement by all appropriate agencies of this provision concerning assignees and all other Truth in Lending Act provisions in order to assure equal protection to all consumers.

Both suggestions of the Board of Governors of the Federal Reserve System pertaining to class action suits and the clarification of the definition of "transactions" be adopted.

The Commission supports the recommendation of the Board of Governors of the Federal Reserve System that Congress amend the Truth in Lending Act specifically to include under Section 125 security interests that arise by operation of law.

The Commission supports the recommendation of the Board of Governors of the Federal Reserve System that Congress amend the Truth in Lending Act to limit the time the right of rescission may run where the creditor has failed to give proper disclosures.

Education (Chapter 11)

The Commission recommends that:

Congress support the development of improved curricula to prepare consumers for participation in the marketplace, with adequate attention to consumer credit as one aspect of family budgeting.

Appropriate federal and state agencies should continue their emphasis on adult education for low income consumers, try to reach more of them, and develop useful programs for the elderly,

Federal resources be used to encourage expanded research and carefully monitored pilot projects to generate and test new ideas in adult consumer education.

Business organizations support and encourage nonprofit credit counseling, provided it is conducted for the benefit of the consumer and does not serve solely or primarily as a collection agency.

If private debt adjusting services are allowed to continue, their activities be strictly regulated and supervised, including their fees and advertising.

Counseling be made a mandatory requirement for obtaining a discharge in both Chapter XIII and straight bankruptcy, unless the counselor in a particular case should determine that counseling would be unnecessary or futile.

The Future of Consumer Credit (Chapter 12)

The Commission recommends that legislation be enacted to achieve the following goals:

1. Each consumer's complaint should be promptly acknowledged by the creditor.

2. Within a reasonable period of time· a creditor should either explain to the consumer why he believes the account was accurately shown in the billing statement or correct the account.

3. During the interval between acknowledgment of the complaint and action to resolve the problem, the consumer should be free of harassment to pay the disputed amount.

4. The penalties on creditors for failure to comply should be sufficiently severe to prompt compliance.

The Commission recommends additional federal and state legislation specifically prohibiting any regulatory agencies from establishing minimum merchant discounts.

The Commission also recommends that studies be undertaken now to consider the eventual federal chartering and regulation of credit reporting agencies, both to assure the accuracy and confidentiality of their credit information and to achieve open and economical access to their data.

CHAPTER 1, APPENDIX B:

Listing of the membership, foreword, staff, and published technical studies of the National Commission on Consumer Finance

Members of the Commission

Appointed by the President:

Ira M. Millstein, Chairman
Attorney
New York, New York
Appointed Chairman January 20, 1971
to succeed Robert Braucher

Dr. Robert W. Johnson
Professor, Purdue University
Lafayette, Indiana

Hon. Douglas M. Head
Attorney
Minneapolis, Minnesota
Appointed February 16, 1971

Appointed by the President of the Senate:

Hon. John Sparkman
Senator from Alabama

Hon. William Proxmire
Senator from Wisconsin

Hon. William E. Brock
Senator from Tennessee

Appointed April 5, 1971 to succeed
Hon. John G. Tower
Senator from Texas

Appointed by the Speaker of the House of Representatives:

Hon. Leonor K. Sullivan
Representative from Missouri

Hon. Henry B. Gonzalez
Representative from Texas

Appointed March 10, 1971 to succeed
Hon. Wright Patman
Representative from Texas

Hon. Lawrence G. Williams
Representative from Pennsylvania

Appointed March 10, 1971 to succeed
Hon. Seymour Halpern
Representative from New York

The Commission's Foreword

The National Commission on Consumer Finance, established by Title IV of the Consumer Credit Protection Act of 1968 (Public Law 90-321), attained its full membership on November 7, 1969 when the President named three public members and designated one of them Chairman.

As originally constituted, Commission members included Robert Braucher, professor of law at Harvard University, who was named Chairman; Robert W. Johnson, professor of finance at Purdue University; and Ira M. Millstein, member of the New York Bar, Presidential appointees; Senator John J. Sparkman, Senator William Proxmire, and Senator John G. Tower, Senate appointees; and Representative Wright Patman, Representative Leonor K. Sullivan, and Representative Seymour Halpern, House of Representatives appointees. When Chairman Braucher subsequently became an Associate Justice of the Supreme Judicial Court of Massachusetts, the President designated Mr. Millstein as Commission Chairman and named Douglas M. Head, former Attorney General for the State of Minnesota, to fill the vacancy. Later, when Senator Tower found it necessary to resign, he was replaced by Senator William E. Brock, and when Representatives Patman and Halpern also found it necessary to relinquish membership, they were replaced by Representative Henry B. Gonzalez and Representative Lawrence G. Williams. Despite these membership changes, however, a majority of the members and the Commission's executive director, Robert L. Meade, have served during the Commission's entire existence. Continuity was further achieved through monthly meetings and frequent written communications.

In a consumer message to Congress on October 30, 1969 President Nixon noted that total consumer credit outstanding had grown during the last 25 years from $5.7 billion to $100 billion and that Government supervision and regulation of consumer credit had become increasingly complex and difficult. The Commission, he said, "should begin its important work immediately."

Because of the wide area such a comprehensive subject could encompass, the Commission had to narrow the scope of its work to fit its funding and time limitations. Even so, the Commission twice had to ask Congress for additional time and once for additional funds. Certainly due in no small part to the interest, understanding, and generosity of the Congress, the Commission now offers this final Report to fulfill its Congressional mandate.

The Commission is confident that it has pioneered in collecting and presenting heretofore unobtainable data and ground-breaking studies and analyses. In and of themselves, the collection and dissemination of these data, the studies, and the analyses will provide a fresh and empirical basis for legislators, the industry, and scholars to consider.

Many of the supporting studies are being published as supplements to the final report for the use of legislators, the industry, scholars, and others interested in the basic data. Unpublished data and studies as well as computer tapes can be read at the records center of the National Archives and Records Service, Washington, D.C.

As to the findings, conclusions, and recommendations contained in the report, these were prepared by the Commission staff based upon the data, studies, and analyses collected by the Commission and, more importantly, based upon the numerous meetings of the Commission throughout its life at which all the Commissioners had the opportunity to present their respective views as the work progressed. As in any report of this nature, not all of the Commissioners agreed with all of the findings, conclusions, and recommendations, as evidenced by the separate views expressed by the individual members, which separate views follow the body of the report.

During the course of its study, the Commission held three public hearings in Washington, D.C. to obtain facts and views from individuals, consumer organizations, industry, and Government on the subjects of debt collection practices, responsibility for enforcement of consumer credit protection laws, and the availability of consumer credit to women. The Commission publicly acknowledges its gratitude to witnesses who appeared at the hearings to provide invaluable information related to ever increasing complexities in the consumer credit field. The Commission also notes its gratitude to thousands of credit industry officials who spent hours of time and effort in completing Commission questionnaires which provided priceless data. Obviously, their assistance in providing data does not necessarily indicate their concurrence with the report and its recommendations.

Although this report is directed to the President and to the Congress, the Commission hopes that consumers, the consumer credit industry, state legislative bodies, and professional and academic communities will also find that it adds substantially to their understanding of a growing industry and a complex subject.

Staff of the National Commission on Consumer Finance

STAFF OF THE COMMISSION

Robert L. Meade
Executive Director

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Public Information Officer

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[1] Until February 5, 1972 [2] Until September 4, 1971 [3] Until November 3, 1971

Technical studies of the National Commission on Consumer Finance

The studies listed below are being published by the Commission and copies may be ordered from the Government Printing Office, Washington, D.C. 20401. Publication by the Commission does not imply its approval, but in many instances Commission findings, conclusions, and recommendations are, in part, based on the studies.

VOLUME I

I. Robert P. Shay and Milton W. Schober.
Consumer Awareness of Annual Percentage Rates of Charge in Consumer Instalment Credit: Before and After Truth in Lending Became Effective.

2. George S. Day and William K. Brandt.
A Study of Consumer Credit Decisions: Implications for Present and Prospective Legislation.

3. Terry Deutscher.
Credit Legislation Two Years Out: Awareness Changes and Behavioral Effects of Differential Awareness Levels.

VOLUME II

1. George J. Benston.
The Costs of Extending Consumer Credit at Consumer Finance Companies and Commercial Banks.

2. George J. Benston.
Continuous High Interest Rate Borrowing and Consumer Welfare: An Analysis of Maine's "36 Months Limitation" on Finance Company Small Loans.

3. Thomas A. Durkin.
A High-Rate Market for Consumer Loans: The Small Small Loan Industry in Texas.

4. Thomas F. Cargill.
Performance of Limited-Income Credit Unions: 1969-1970.

VOLUME III

Robert P. Shay and Milton W. Schober.
A Statistical Compilation of Credit Rates, Extensions, and Outstandings in Consumer Credit Markets in the United States in 1971.

VOLUME IV

Edited by Douglas F. Greer and Robert P. Shay.
An Econometric Analysis of the Consumer Credit Market in the United States in 1971.

Part I:

1. Douglas F. Greer.
A Theory of Credit Rationing.

2. Douglas F. Greer and Robert P. Shay.
Preliminary Model Specifications for the Personal Loan Market.

3. Douglas F. Greer and Robert P. Shay.
Preliminary Model Specifications for the New Automobile Credit Market.

4. Douglas F. Greer and Robert P. Shay.
Preliminary Model Specifications for Other Consumer Goods Credit Market.

5. Ernest A. Nagata and Douglas F. Greer.
Preliminary Model Specifications for Mobile Home Credit Market.

Part II:

1. Douglas F. Greer.
An Empirical Analysis of the Personal Loan Market.

2. Douglas F. Greer and Ernest A. Nagata.
An Empirical Analysis of the New Automobile Credit Market.

3. Ernest A. Nagata and Douglas F. Greer.
An Empirical Analysis of Other Consumer Goods Credit.

4. Ernest A. Nagata and Douglas F. Greer.
An Empirical Analysis of the Mobile Home Credit Market.

5. Robert P. Shay.
The Impact of State Legal Rate Ceilings upon the Availability and Price of Consumer Instalment Credit.

6. Richard K. Slater and Douglas F. Greer.
The Role of Finance Income in Gross Profit Margins of Automobile Dealers.

VOLUME V

Alan R. Feldman and Douglas F. Greer.
Creditors' Remedies and Contractual Provisions: A Legal and Economic Analysis of Consumer Credit Collections.

VOLUME VI

1. William C. Dunkelberg.
An Analysis of the Impact of Rate Regulation in the Consumer Credit Industry.

2. Paul F. Smith .
The Status of Competition in Consumer Credit Markets.

The studies listed below and prepared for the Commission may be perused at the Records Center of the National Archives and Records Service, Washington, D.C.:

1. Gary G. Chandler.
An Analysis of the Debt Positions of Poverty Area Families

2. Ronda F. Paul.
A Study of Credit Granting Systems for Low-Income Consumers.

3. Darrell A. McNabb.
An Inquiry into the Response of Durable Goods Retailers to a Reduction in the Statutory Ceiling on Consumer Credit Charges.

4. Stephen M. Crane.
A Study of Deficiency Suits for Automobile Credit Transactions in the District of Columbia.

5. Milton W. Schober.
A Study of the Costs of Extending Retail Sales Credit.

6. Sylvia Lane.
An Analysis of Credit Counseling Programs.

CHAPTER 1, APPENDIX C:

Listing of Members and staff of the Taskforce on Federal Consumer Financial Law

Members of the Taskforce

Todd J. Zywicki, J.D.
Taskforce Chair, CFPB
Professor of Law, George Mason University

J. Howard Beales, Ph.D.
Taskforce Member, CFPB
Emeritus Professor, George Washington University
Formerly Director, Bureau of Consumer Protection, Federal Trade Commission

Thomas A. Durkin, Ph.D.
Taskforce Member, CFPB
Senior Economist (Retired), Board of Governors of the Federal Reserve System

William C. MacLeod, J.D.
Taskforce Member, CFPB
Attorney
Formerly Director, Bureau of Consumer Protection, Federal Trade Commission

L. Jean Noonan, J.D.
Taskforce Member, CFPB
Attorney
Formerly General Counsel, Farm Credit Administration

Staff of the Taskforce

Nathaniel J. Weber, Staff Director

Gregory Elliehausen, Chief Economist

David H. Hixson, Senior Counsel

Jeffrey S. Magliato, Paralegal

Alexander K. Nongard, Director's Financial Analyst

Ross Rutledge, Economist and Senior Advisor

Ashley N. Tarpley, Senior Counsel

2. Extent and growth of consumer credit

Credit use by individuals is certainly not a 21st century phenomenon; it actually is as old as recorded human history and probably much older. Credit use is known from the Bible, ancient India and Babylon, the Greek city states, the Roman Republic, and medieval Europe. It may well have originated in Neolithic times when individuals down on their luck needed help with necessities. Biblical prohibitions on taking advantage of brothers in need by charging them for credit argued for centuries the influential religious view that the absence of charity in such situations was sinful.[1] Civil restrictions on credit use likewise are ancient.

2.1 Development of Modern Consumer Credit

But before the 20th century, absence of what today are common consumer goods and services like automobiles, appliances, recreational durable goods, commercial home-improvement services, and widespread higher education precluded the need or desire for much of today's phenomenon of consumer credit. In the more distant past, credit use by individuals for noncommercial purposes probably most often did reflect necessitous situations where charity was another possible answer.

History shows, however, that use of credit by artisans and tradespeople also flourished in ancient times, and that it was subject to the same kinds of religious and civil regulatory prohibitions as necessitous credit in the European Middle Ages. This thinking began to change in the later Middle Ages with the spread of trading economies. At the time, merchants often needed to acquire trade goods on credit for resale, but changes in religious views about credit

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[1]See *Exodus* 22:25, *Leviticus* 25:35-37, and *Deuteronomy* 23:19-20.

use still took centuries. Even then, it took more centuries for evolving beliefs to move beyond business and trade-related credit to other credit for individuals.

Religious opposition to lending at interest gradually faded with development of more robust commerce and trade during the Renaissance/Reformation/Enlightenment centuries and later, but it seems like widespread cultural and governmental anxiety over personal lending and borrowing has never completely gone away, even as secularization of economic and commercial affairs has advanced. At least some of modern governmental concerns over consumer credit appear to arise from society's remaining basic ambivalence about whether credit use by individuals is good for them or not, perhaps a modern vestige of the ancient and medieval view that lending is questionable or even immoral. Modern economic analysis has shown that there are many situations where credit use is beneficial to consumers (see Chapter 3), but the issue is still not settled completely to the satisfaction of everyone. Nonetheless, it is obvious that there has been a strong, long-term trend toward greater acceptability of credit use by individuals as a feature of modern life.[2]

Domestically in what became the United States, from colonial times through the 1850s there was credit use but mostly as a substitute for circulating coin money that often was in short supply or for what we would today consider business purposes. Farmers as producers, for example, borrowed to acquire land for crops. As consumers, they also often purchased shop goods on credit while they waited for the harvest and the barter or sale of farm goods to repay the merchants. Artisans of various sorts also extended credit if they, like the shopkeepers, were to sell their services and be paid at all. Promissory notes and similar documents often circulated like money. This kind of credit system lasted for many years in many places.[3]

But it was the coming of urbanization and expansion of town and city dwelling and the accompanying middle class after the Civil War, along with the invention of new consumer goods

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[2]For extended discussion of ancient and medieval views of credit and its regulation and the impact of the Enlightenment, *see* SIDNEY HOMER AND RICHARD E. SYLLA, A HISTORY OF INTEREST RATES (New Brunswick, NJ: Rutgers University Press, 1999) and ROSA-MARIA GELPI AND FRANCOISE JULIEN-LABRUYERE, THE HISTORY OF CONSUMER CREDIT (New York: St. Martin's, 2000). *See also* Paul B. Rasor, *Biblical Roots of Modern Consumer Credit Law*, 10 Journal of Law and Religion 157–192 (1993).

[3]For colorful examples and extended review of credit use (and other activities) in the early nineteenth century by frontiersman and politician David Crockett, land speculator James Bowie, and lawyer William B. Travis, all of whom lost their lives and their debts at the Alamo in 1836, *see* WILLIAM C. DAVIS, THREE ROADS TO THE ALAMO: THE LIVES AND FORTUNES OF DAVID CROCKETT, JAMES BOWIE, AND WILLIAM BARRET TRAVIS (New York: HarperCollins, 1998).

such as automobiles and electrical appliances somewhat later, which led to the modern phenomenon of consumer credit that is so familiar today. Although there always have been necessitous loans in the absence of sufficient charity and other economic relief, there simply was little need before the 1920s for the auto loans, boat loans, durable goods credit, college tuition credit, and home modernization and repair loans that make up the bulk of consumer credit use today. The interwar years saw considerable growth of consumer credit, but most of the expansion came in the years after World War II. As indicated, the reasons for credit use and growth are explored further in Chapter 3.

Credit regulation expanded with the development of credit for individuals. From ancient times to the early 20th century, credit regulation consisted mostly of interest-rate limits. Rate ceilings reflected the historical, religious, and social prohibitions against benefitting from the difficulties of others. But rate ceilings also made extensions of small amounts of credit to necessitous or other consumer-borrowers unprofitable for existing commercial-lending enterprises like banks as economic life secularized. Rate ceilings at the state level persisted in the United States as the economy began to modernize after the Civil War, preventing the lending of small amounts of credit for individuals. (At the time, virtually all credit regulation in the United States was at the state or local level.) This did not extinguish the need for emergency credit during these years, however. At the time, many individuals in the newly urbanized segments of the population, now often disbursed from their extended families, obtained credit from lenders operating outside the state laws. The post-Civil War period in the United States up to about 1915 has subsequently become known as the "illegal lending" or "loan shark" period of consumer credit.[4]

Beginning about 1910, reformers and commercial enterprises took aim both at the prevalence of loan-shark providers of necessitous credit and the developing opportunities to aid in the sale of new consumer goods and services profitably. Both sorts of effort led to the spread of new kinds of consumer-lending institutions.

Reform efforts of the Russell Sage Foundation beginning in October 1910 led first to supporting semi-philanthropic lenders, also known as "remedial lenders" and "remedial pawn shops." These lenders would use philanthropic capital and lend using fair but business-like methods. By

[4]For further discussion of credit use and difficulties during these years, *see* LOUIS N. ROBINSON AND ROLF NUGENT, THE REGULATION OF THE SMALL LOAN BUSINESS (New York: Russell Sage Foundation, 1935); *see also* IRVING S. MICHELMAN, CONSUMER FINANCE: A CASE HISTORY IN AMERICAN BUSINESS (New York: Augustus M. Kelley, 1970); *see also* HOMER AND SYLLA, A HISTORY OF INTEREST RATES, op. cit.; LENDOL C. CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT (Princeton, NJ: Princeton University Press, 1999); GELPI AND JULIEN-LABRUERE, THE HISTORY OF CONSUMER CREDIT, op. cit.; *and* ANNE FLEMING, CITY OF DEBTORS (Cambridge, MA: Harvard University Press, 2018).

1916, the reform-oriented Sage Foundation determined that this approach was insufficient to address the loan-shark problem due to inability of the semi-philanthropic lenders to attract sufficient lending capital. Consequently, the foundation joined forces with willing commercial lenders to sponsor legislation in the states enabling formation of state-regulated cash lenders of small amounts. These lenders would operate under legislated exceptions to each state's overarching rate-ceiling requirement, permitting higher but regulated rates for this purpose.

At the time, lenders based upon the Sage Foundation reforms and related state-regulation efforts were known as small-loan companies or licensed lenders. They still exist today in some states as the traditional installment-lending industry. An important event took place in 1932 when New York Governor Franklin D. Roosevelt requested that the legislature of the most populous state pass the reform legislation, which it did unanimously in both houses. By the 1960s, laws based upon the Russell Sage Foundation's efforts existed in almost every state. Since then, changes in or inattention to updating legal requirements as inflation and other economic changes have ensued mean these lenders have become archaic and attenuated or absent in many states, although they still exist in others.

The decade of the 1910s also witnessed formation of other kinds of consumer lenders. They included credit unions, similar in basic intent to those still operating as cooperatives today, although more primitive and smaller than the modern ones.[5] "Industrial workers' banks" that operated under a complicated lending plan to get around rate ceilings and offer installment credit to industrial workers, known as the Morris Plan, were another new kind of institution. A Virginian named Arthur Morris opened the first Morris Plan Bank in Norfolk in 1910.[6]

As a practical matter, the Morris Plan banks amounted to finance companies that took deposits. Their lending plan became the forerunner of consumer lending by the commercial banking industry, but commercial banks did not enter the field until the late 1920s and then only tentatively. Most of the growth in bank consumer lending occurred after World War II. In 1951, the Franklin National Bank of New York became the first bank to issue bank credit cards. Morris

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5The first US credit union was established in New Hampshire in 1909, but credit unions did not spread beyond a few eastern states until the 1920s.

6The Morris plan allowed banks to make small loans profitably under existing laws. The Morris plan loan charged a legal rate of interest but collected interest at origination out of the loan principal. The bank obtained additional funding by requiring the borrower to purchase non-interest-bearing certificates. The borrower's payments were credited to purchase of the certificates, not to reducing the loan principal. When the required certificate purchases were completed, the certificate was cancelled, with the proceeds from the cancellation being used to repay the loan.

Plan banks and commercial banks making consumer loans eventually became subject to their own sets of state regulations, including further exceptions to state-based rate ceilings specifically put in place for them. Many of the old Morris Plan banks and loan companies later evolved into commercial banks.

The 1910-1920 period also saw early finance companies formed to facilitate the sales of the merchandise of related manufacturers. The manufacturers came to believe they could sell a lot more output if they also financed the sale. For example, the General Motors Company formed the General Motors Acceptance Corporation (GMAC) in 1919 to aid the sales of the parent. Many consumers took advantage of the opportunity to acquire this new consumer durable good and use it immediately.[7] Over time, GMAC became the largest finance company in the world. (Today, a remnant survives as Ally Bank, no longer a subsidiary of General Motors.) Other manufacturers also formed sales-finance subsidiaries, often known then and now as "captives." Today, independent companies also finance sales, including new and used cars, motorcycles, recreational vehicles, mobile homes, boats, and aircraft. In addition, there are many business-lending finance companies.

Regulation of these sales-finance firms was different from small-loan finance companies. Courts decided that financing a specific sale was not a loan for regulatory purposes. Rather, these were sales of goods "on time" and not loans of money that triggered lending laws. Under this conception, the difference between the price of a sale for cash today and the total price over time (called the "time-price differential") was not interest and not subject to state interest-rate ceilings.[8] The same thinking applied to consumer financing by retail stores and dealers. Eventually, most states also regulated time-price differentials.

Consequently, all these institutions came under a range of different state laws and regulations. Small-loan companies were regulated under versions of the Uniform Small Loan Law, sponsored by the reform-minded Russel Sage Foundation, and in some states also by other laws legislated for larger loans. Morris Plan lenders, many of which later became banks, were regulated under laws specifically for such lenders and banks. Credit unions had their own laws. So did the sales finance companies and retail outlets regulated by sales finance codes often known as "all goods" acts. In 1972, the National Commission on Consumer Finance (NCCF) complained about the range and sometimes Byzantine interaction of all these laws regulating

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7The early development of automobile financing and its important role in spurring competition in car manufacturing and making automobiles accessible to ordinary Americans is discussed in Chapter 9.

8*See* Hogg v. Ruffner, 66 U.S 115 (1861).

types of credit, loan sizes, and institutions differently as barriers to effective competition in markets for consumer credit.

Referring to Barbara A. Curran's 1965 compilation of state laws, the NCCF wrote in its *Report* in 1972 (p. 94):

> A compilation of consumer credit legislation reveals the present hodgepodge of legislation characteristic of most states. As one example, New York has separate statutes regulating installment loans by commercial banks, loans by industrial banks, bank check-credit plans, revolving charge accounts, motor vehicle installment sales financing, installment financing of other goods and services, insurance premium financing, loans by consumer finance companies, and loans by credit unions. The general usury rate is 6 percent (currently 7 1/2 percent under special rule of the Banking Board), and criminal penalties apply if interest is over 25 percent [footnote omitted]. But the decreed maximum rates to obtain $500 of credit, repayable monthly over 12 months, range widely: bank personal and improvement loans, 11.6 percent; industrial banks, 14.5 percent; used cars up to 2 years old, 17.7 percent; used cars over 2 years old, 23.2 percent; small-loan companies, 24.8 percent; other goods, 18.0 percent; retail revolving credit 1 1/2 percent on monthly balances up to $500 and 1 percent monthly on balances in excess of $500.

The variety of rate ceilings that has developed on an *ad hoc* basis creates barriers to competition among segments of the consumer credit industry. Given a maximum rate of 11.6 percent in New York, commercial banks will not enter the $500-loan market served by consumer finance companies at 24.8 percent.[9]

The regulatory trend since the NCCF's time has generally been in the direction of homogenization of laws and regulatory regimes affecting consumer credit. On balance, states have tended to adjust their credit laws in the direction of greater consistency of regulation across the classes of lenders and lending within their boundaries. There is still diversity within states and considerable diversity among states, however.

Eventual federal legislation is a bit more focused within its spheres of activity: Beginning with the Truth in Lending Act in 1968, the Fair Credit Reporting Act in 1970, and the Equal Credit Opportunity Act in 1974 and 1976, federal rules for the most part apply to all consumer creditors in the same way. Later in 2010, the Dodd-Frank Act established the Consumer Financial

[9]Note: Bank credit cards were a lot less common at that time than more recently, but they also had rate ceilings.

Protection Bureau to be a consistent federal voice in consumer credit with ongoing responsibilities.

Despite partial homogenization and federal regulatory entry, regulatory overlaps and difficulties remain, however. There still are differences in regulation among states and sometimes within them. Now there is also an ongoing federal presence that raises further questions of overlapping jurisdictions, including questions of the desirability, or not, of federal preemptions of state laws. These jurisdiction issues are discussed further later in this report, especially in Chapters 6 and 13.

2.2 Consumer Credit Growth

Consumer credit certainly *seems* important today. As indicated in Chapter 1, domestic consumer credit outstanding (exclusive of mortgage credit) rose from about $6.8 billion at the end of 1945 and wartime restrictions (about $99 billion in 2019 dollars) to $4.2 trillion at the end of 2019. This section of this chapter outlines the types of consumer credit in widespread use today and briefly reviews aspects of their growth over the decades. Chapter 3 then discusses further the meaning of "types of credit" and why certain types of credit account for much of the consumer credit extended.

In 1972, the NCCF provided an examination of consumer credit outstanding at the time and its growth since World War II in its Chapter 2. The NCCF was able to employ statistics on consumer credit continuously collected by the Federal Reserve since 1943, the same ongoing statistical series used here. The Federal Reserve's data collection effort began when federal wartime restrictions on both consumer goods production and consumer credit use on account of inflationary concerns made consumer credit a federal policy matter for the first time (Regulation W, see footnote in Chapter 1 of this report).

As consumer credit grew in the postwar years, the Federal Reserve Board has maintained this data collection, updating and revising it as credit types and markets changed over time (see Federal Reserve monthly statistical release "Consumer Credit - G19" and the historical series underlying it). After the war, the Federal Reserve also began its program of collecting information about the distributions of assets and debt among the public through the Surveys of Consumer Finances program that also extends to the present. The Surveys of Consumer Finances were begun by the Survey Research Center of the University of Michigan in 1946 with the support of the Federal Reserve and others in later years. Since 1992, the National Opinion Research Corporation of the University of Chicago has undertaken the survey field work.

Modern consumer credit is diverse enough that it can be classified in many ways. In recent years, the Federal Reserve has divided the totals in three ways: The first is by the means that credit is generated and repaid (nonrevolving versus revolving credit). The second is by institutional source of the funds (eight kinds of institutions in recent years, reduced to seven through a combination of certain statistics after mid-2020). Since 2013, the Federal Reserve has also released statistics a third way, according to two uses of consumer loans: automobile credit (including consumer trucks and motorcycles but not consumer leases) and student loans. The separate figures by purpose extend back to 1943 for auto credit and to 2006 for student loans. The following paragraphs highlight some of the Federal Reserve's statistical information on consumer credit.[10]

The first grouping of consumer credit amounts outstanding is by method of credit advance and repayment (upper part of Table 2-1 for current dollars and middle part of the table for 2019 dollars). Two methods of advance and repayment are widespread today. The first is nonrevolving credit, where the amount of the credit advance and the size and timing of repayments are determined in advance by contract (for instance, automobile credit). In terminology used by Truth in Lending, this kind of credit is also known as "other than open-end" consumer credit, or more familiarly as "closed end" consumer credit.

[10] In their 2014 book, Durkin, Elliehausen, Staten, and Zywicki examine the background and changing kinds of statistics and components of consumer credit in the postwar period in considerably more detail than attempted here. They also examine credit growth itself in much more detail. *See* THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY (New York: Oxford University *Press*, 2014), Chapters 1 and 2.

TABLE 2-1: CONSUMER CREDIT OUTSTANDING, END OF SELECTED YEARS, 1945-2019

	1945	1955	1965	1975	1985	1995	2005	2010	2015	2019
					Billions of Current Dollars					
By Type of Credit										
Nonrevolving	7	43	97	192	479	703	1464	1808	2504	3097
Revolving				15	132	465	857	839	907	1094
Total	7	43	97	207	611	1168	2321	2647	3411	4191
By Type of Institution										
Depository Institutions	3	19	49	116	355	542	816	1186	1428	1771
Finance companies	1	12	24	33	112	152	517	705	561	537
Credit unions	*	1	6	26	74	132	229	226	342	482
Nonfinancial business	3	11	18	33	63	85	60	44	38	40
Pools of securitized assets						213	610	50	46	14
Federal government[1]					7	44	90	364	950	1319
Nonprofit and educational inst.[2]								71	45	28
Total	7	43	97	207	611	1168	2321	2647	3411	4191

	1945	1955	1965	1975	1985	1995	2005	2010	2015	2019
					Billions of 2019 Dollars					
By Type of Credit										
Nonrevolving	99	410	787	912	1138	1179	1916	2120	2700	3097
Revolving				71	314	780	1122	984	978	1094
Total	99	410	787	983	1452	1959	3039	3103	3679	4191
By Type of Institution										
Depository Institutions	43	181	398	551	843	909	1068	1391	1540	1771
Finance companies	14	114	195	154	266	255	676	827	605	537
Credit unions	*	10	49	124	176	221	300	265	369	482
Nonfinancial business	43	105	146	153	150	143	78	52	41	40
Pools of securitized assets						357	799	59	50	14
Federal government[1]					17	74	118	427	1025	1319
Nonprofit and educational inst.[2]								83	49	28
Total	99	410	787	983	1452	1959	3039	3103	3679	4191

	1945	1955	1965	1975	1985	1995	2005	2010	2015	2019
	Percent of Total Consumer Credit (Current and Constant Dollars)									
By Type of Credit										
Revolving				7	22	40	37	32	27	26
Nonrevolving	100	100	100	93	78	60	63	68	73	74
Total	100	100	100	100	100	100	100	100	100	100
By Use of Credit										
Motor vehicles	7	31	30	28	35	31	35	27	29	28
Federal student loans[1 2]					1	4	4	16	29	32
"Other"	93	69	70	72	43	25	24	25	15	13
Total	100	100	100	100	100	100	100	100	100	100

Source: Federal Reserve Statistical Release G19, "Consumer Credit," Historical Data. Figures shown are for December, not seasonally adjusted. Columns may not add exactly to totals because of rounding.

* Greater than zero but less than one half billion.

[1]Includes student loans originated by the Department of Education under the Federal Direct Loan Program and the Perkins Loan Program, as well as Federal Family Education Program loans that the government purchases under the Ensuring Continued Access to Student Loans Act.

[2]Includes student loans originated under the Federal Family Education Loan Program and held by educational institutions and nonprofit organizations. Federal student loans in this panel of the table do not include student loans made by private sources and included within totals for depository institutions and finance companies that are in "other" loans.

The second method of advance and repayment is revolving credit, where both the amount and timing of the advance and the amount of monthly repayment are decided upon by the consumer, subject to a maximum credit size and some minimum monthly payment amount (for example, credit-card credit which is the bulk of this kind of credit). This kind of credit is also widely called "open-end" consumer credit. Before 1968, the Federal Reserve did not make the distinction in the statistical series between nonrevolving and revolving credit (closed and open-end credit), but the growing innovation of the three-party credit card at around that time (consumer, merchant, and financial institution) and passage of Truth in Lending that year that made this distinction argued for this new classification.[11] Revolving or open-end forms of consumer credit today account for about a quarter of the total. Nonrevolving or closed-end forms of consumer credit account for about three-quarters of consumer credit today, about $3 trillion at present.

An alternative way of grouping consumer credit is according to institutional source of the credit (lower portion of the top and middle panels of Table 2-1). The listed institutions are the ultimate lenders of the amounts (for instance, depository institutions and finance companies). They are not necessarily the same institution with whom the consumer actually originates the transaction

[11]The term "three-party credit card" (consumer, merchant, and financial institution that issues the card to the consumer), a term in use since the originator known as the Diners Club in the early 1950s, refers to the consumer side of this transaction. It should not be confused with the three or four-party processing networks that manage the electronic processing of the transaction among merchants, banks, and their electronic settlement networks.

and takes on the obligation (such as finance offices of automobile dealers or colleges). Frequently, originating lenders sell the promissory notes to the ultimate lenders shortly after closing of the originating transaction, a procedure called "indirect credit."

The largest suppliers of consumer credit are depository institutions, mostly commercial banks. Much of commercial bank consumer credit in recent years is through their credit card operations. Credit unions comprise their own group, although they also are depository institutions. The reason for making this particular distinction among depositories is to provide a bit more information about kinds of depositories but without also requiring separate groupings today for remaining other sorts of depositories that are now small in number. These others include savings banks and savings and loan associations, today lumped with commercial banks and referred to as "depository institutions." Within the quarter of consumer credit that is revolving credit, depositories hold the lion's share, mostly through their credit card programs using the American Express, Discover, MasterCard, and Visa brand names, the latter two names used by many separate depositories.

The fastest growing provider of consumer credit in recent years is the federal government. The growth in the federal government category reflects the recent expansion of a variety of federal student loan programs that have come to dominate educational lending. The federal government is now the second largest institutional source of consumer credit (Table 2-1). Some student loans are still made and held by other lending institutions like the former federal lending affiliate Sallie Mae (now a private depository institution). These other student loans are counted within the commercial banking and finance company sectors, but the bulk of student lending today is held by the federal government.

After depository institutions and the federal government, finance companies and credit unions are the remaining large institutional suppliers of consumer credit. The decline in the finance company category in recent years reflects the reclassification of federal loans formerly held by federal affiliate Sallie Mae that became a private company some years ago, from the finance company group then to the newer federal government category now.

Residual suppliers include nonprofit educational institutions (mostly colleges), nonfinancial businesses (like retail stores and auto dealers), and pools of securitized assets. The latter are consumer credit assets such as auto and credit card receivables (loans) that lenders form into pools supporting securities sold in worldwide financial markets. This method of obtaining the funding for consumer credit once was much larger than at present, until changes in accounting requirements a little over a decade ago required moving the assets back onto the books of the lender and making this method of obtaining funds for lending much less attractive (see table).[12] Recently, the amounts in this category have become small enough that the Federal Reserve eliminated this category beginning in the second half of 2020; it is included in Table 2-1 because this lending source was very large only a few years ago and there is still some interest in what these amounts were.

The third panel of the Table 2-1 shows that within the components of nonrevolving consumer credit, motor-vehicle credit has remained around one-quarter to one-third of total consumer credit since the early years of the post-World War II period. In contrast, the innovation of revolving credit associated with three-party credit cards grew rapidly beginning in the 1960s, rising to 7 percent of consumer credit by 1975 and to 40 percent by 1995.

Looking further at the third panel of the table also shows that the three-party credit card was mostly a technological change that brought about replacement for much of "other" consumer credit in the form of credit for household durable goods, appliance, and repair credit. Formerly, individuals desiring to purchase televisions, carpeting, refrigerators and other household items using credit needed to visit the "credit department" of the store or dealer to arrange the financing. Much of this credit was provided by finance companies that purchased the loans from the retailers. Using this new form of revolving credit obviated this need in many cases and was much more convenient for consumers. This change is clear even in the aggregate statistics in the third panel of Table 2-1. The portion of "other" nonrevolving consumer credit dropped sharply 1965-1995 as revolving credit use grew.

Another important trend in the figures reflects the recent growing importance of federal student loans. The volume of these student loans has become great enough in recent years that the proportions of all the other kinds of consumer credit (revolving, vehicle, and "other") have declined. More will be said about student loans in Chapter 12.

One of the questions that sometimes arise from the statistics on amounts of consumer credit in use is whether these totals have risen "too fast" or are now "too high." This is an old area of economic inquiry and review that sometimes produces the responses "compared with what?" and "what is too high?" There are several ways of looking at these questions.

Durkin, Elliehausen, Staten, and Zywicki examined them at considerable length in 2014 and looked at past reviews by others of what had been known earlier as the "debt-burden" issue.[13]

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[12]Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 167 (2009).

[13]See Durkin, et al., *Consumer Credit and the American Economy*, op. cit. Chapter 2.

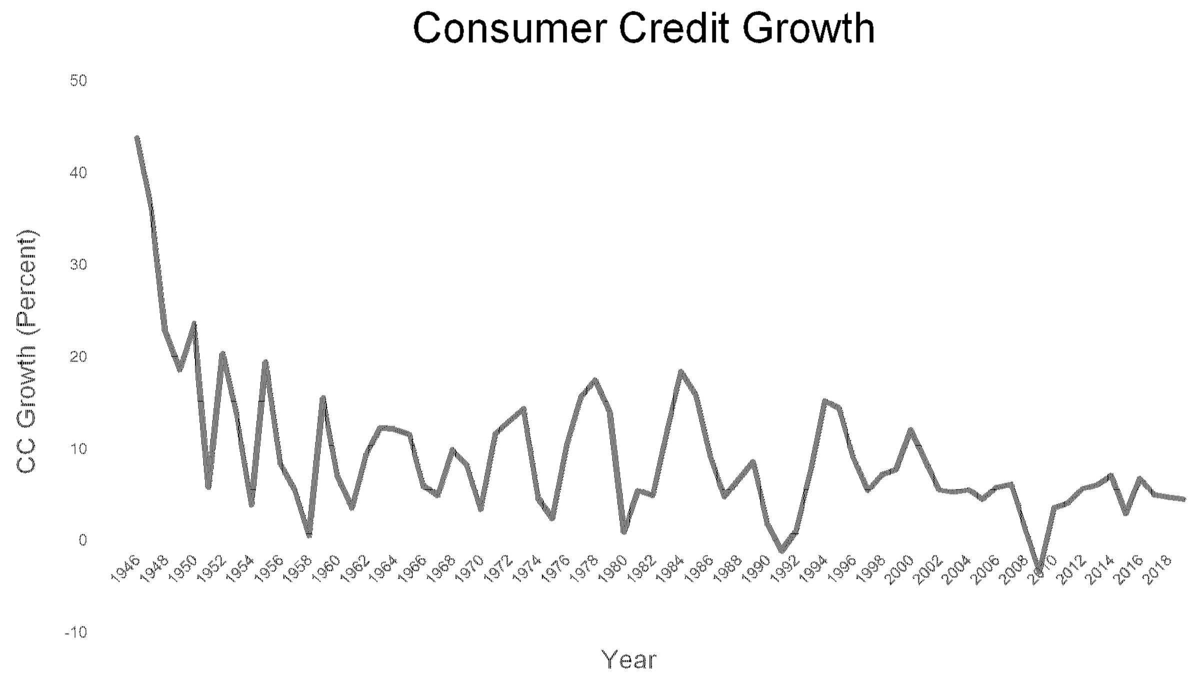
They also reviewed many studies undertaken in this area over the decades since World War II. They concluded that recent consumer-credit growth trends, after taking into account inflation and the growth of other economic variables such as income and assets, were much like those in earlier periods, after rapid early postwar growth in the 1950s. Updating their tables and charts to the end of 2019 provides a largely similar assessment today.

As the NCCF suggested in 1972, one way of looking at consumer credit trends is to compare them with themselves; in other words, examining their growth rate over time. Does the growth rate of consumer credit exhibit a recent trend that looks out of the ordinary, or has growth changed recently in some substantial or significant way? Another is to compare consumer credit with the other important economic quantities mentioned: general inflation, income, and assets.

It turns out that the consumer-credit growth rate has always been cyclical, rising for some time after a recession before leveling out and then declining before the next recession approaches and occurs. The recent rapid decline in the consumer-credit growth rate associated with the COVID-19 recession in 2020 is consistent with previous recessionary declines typical in consumer-credit growth.

Growth experience in recent decades has been much like past experience on this measure (see Figure 2-1). The highest growth rates were in the late 1940s and early 1950s. The aggregate amounts of credit have become larger as the economy has experienced population and income growth (plus inflation) over the postwar period, but recent nominal growth rates of consumer credit have been well within experience of the past six decades. If not for student lending, consumer-credit growth over the recent decade would actually be lower recently than often typical in the past.

FIGURE 2-1: CONSUMER CREDIT GROWTH



2.3 Consumer Credit Growth and Means of Repayment

But consumer credit is not the only economic quantity to grow in the postwar period; employment, income, savings, and assets of the household sector also have grown. Perhaps more interesting than credit growth in isolation is to look at long-term consumer credit growth relative to the means of repayment: income and assets.

Consumer credit relative to household income rose rapidly in the years following World War II, the period that encompassed the greatest percentage rises in consumer credit historically. The increases at the time reflected a variety of important factors such as renewed availability of consumer durable goods like autos and appliances after the end of wartime production restrictions, but the growth rates then seem to have established a view in the press and elsewhere that consumer credit always grows relative to income.[14] Other factors included rising

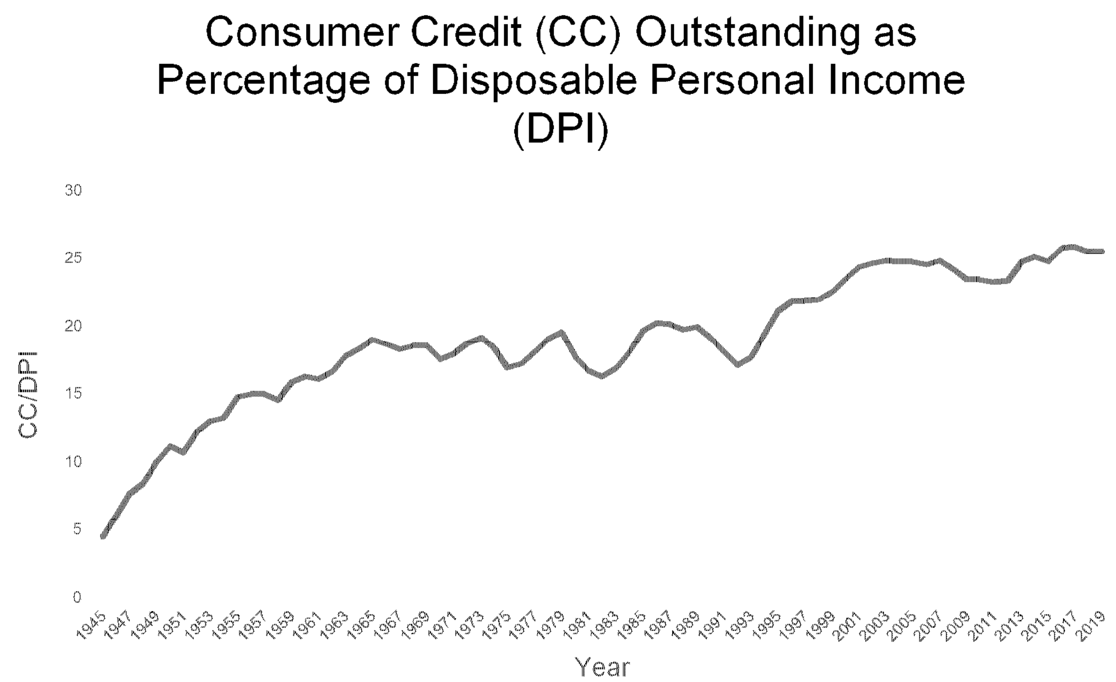
[14]A number of economic analysts studied these trends in the early postwar period and concluded otherwise. Especially, *see* Alain Enthoven, *The Growth of Installment Credit and the Future of Prosperity,* American Economic

and more stable postwar income and prospects, as the Great Depression faded further into the past. Higher and more stable income allowed consumers to devote more discretionary resources to durable goods and their financing. The beginning of the sustained move to the suburbs was also important. With migration to the newly developing postwar subdivisions, demand increased for transportation assets, appliances, and furniture for the new suburban homes likely contributing to the increase in credit use at the time.

Figure 2-2 illustrates the long-term trend of total consumer credit relative to household disposable personal income (after-tax income) since World War II. The chart shows that after postwar growth from a low level, the trend in this ratio largely leveled out by 1963 followed by a slow upward trend afterward.

Review, 47(6), 913 (1957); *see also* Helen Manning Hunter, *A Behavioral Model of the Long-Run Growth of Aggregate Consumer Credit in the United States*, Review of Economics and Statistics, 48(2), 124 (1966); Michael J. Prell, *The Long-Run Growth of Consumer Installment Credit – Some Observations*, Federal Reserve Bank of Kansas City Monthly Review, September, 1973; *and* Charles A. Luckett and James D. August, *The Growth of Consumer Debt*, Federal Reserve Bulletin 71, 389 (1985). For extended discussion of these and other studies on this question, see DURKIN, ET AL., CONSUMER CREDIT AND THE AMERICAN ECONOMY, op. cit. Chapter 2. *Federal.*

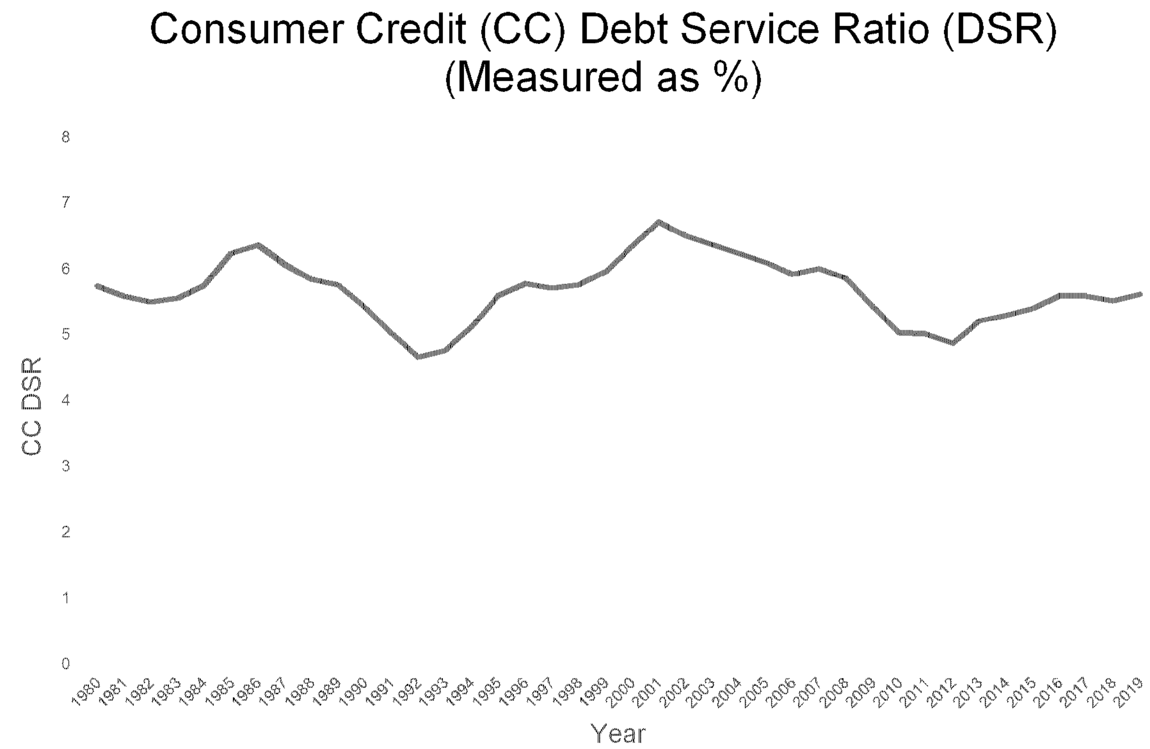
FIGURE 2-2: CONSUMER CREDIT (CC) OUTSTANDING AS PERCENTAGE OF DISPOSABLE PERSONAL INCOME (DPI)



Although Figure 2-2 does not really show much growth in consumer credit relative to income very recently, there is, of course, no reason this ratio of consumer credit relative to income should not continue to rise slowly. As income rises and necessities become a smaller proportion of income for many families, the goods and services like autos, home modernization, and higher education that stimulate credit use can become a larger segment of overall budgets. This change undoubtedly has been true for many families, contributing to the slow rise in this ratio (witness, for example, the increase in multiple-car families since the 1950s, along with more appliances and recreational durable goods and more higher education). Increases in two-earner families over time also suggest the availability of more income to devote to the kinds of goods and services often purchased using credit. The important message here is that this ratio has risen over time since the end of World War II, but it does not indicate some dramatic increase recently, despite what sometimes seems like widespread belief to the contrary.

Significantly, lengthening maturities of consumer credit contracts also increase the amount of credit outstanding as repayments slow, but they have the opposite effect on the actual burden on users by reducing amount of current repayments relative to income. Beginning in 1980, the Federal Reserve has provided a statistical series of consumer-credit repayments compared with household income, the actual burden of debt on household finances (see Figure 2-3).[15] This series shows no trend over the years 1980-2019 and was actually lower at the end of 2019 than in 1980.

FIGURE 2-3: CONSUMER CREDIT (CC) DEBT SERVICE RATIO (DSR) MEASURED AS %



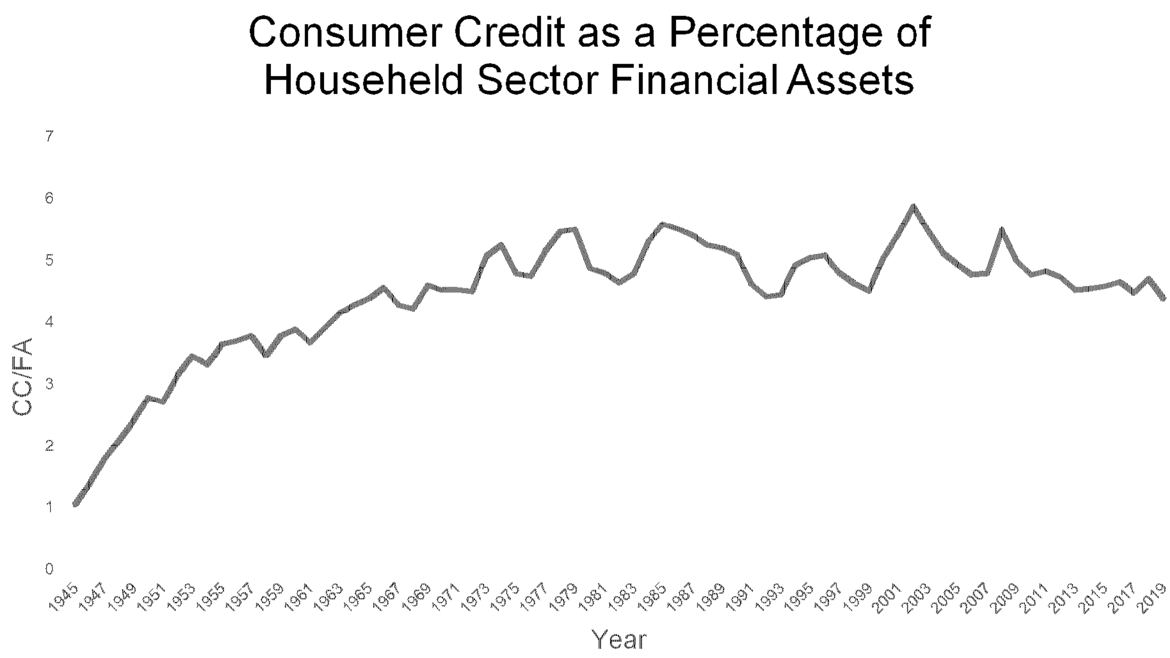
Assets, and particularly liquid assets, represent other means of repayment. There has been considerable concern in recent years that a portion of the population remains very illiquid and often unable to deal easily with financial emergencies that might arise.[16] This could make them candidates for small amounts of necessitous credit, sometimes argued as abusive kinds of credit. But, as described in Chapter 4, the bulk of the population holds substantial amounts of financial assets of various kinds that also are part of the household-sector financial structure and can serve as needed as means of credit repayments.

[15]The Federal Reserve calls this the Household Debt Service Ratio or DSR, released quarterly in an unnumbered statistical release.

[16]For instance, *see* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT ON THE WELL-BEING OF US HOUSEHOLDS IN 2018 (Washington: Board of Governors of the Federal Reserve System, 2019) and similar reports annually in the previous five years.

Figure 2-4 shows overall consumer credit outstanding relative to household sector financial assets measured by the Federal Reserve's Financial Accounts of the United States series (formerly known as the Flow-of-Funds accounting system, see Federal Reserve quarterly Statistical Release Z1). Financial assets include liquid assets like deposits and close substitutes, plus bonds, stocks, and mutual fund shares.

FIGURE 2-4: CONSUMER CREDIT AS A PERCENTAGE OF HOUSEHELD SECTOR FINANCIAL ASSETS



The chart shows that aggregate consumer credit has remained consistently at 4 percent to 5 percent of aggregate household-sector financial assets since the 1950s. Consumer credit outstanding has remained consistently about one-fifth to one-quarter of household-sector liquid assets (deposits and close substitutes) since the early 1960s (not shown in the figure). Most recently (2019), this measure is about at the middle of its range over this time, at 22 percent.

2.4 Distribution of Consumer Credit within the Population

Of course, statistics of aggregate amounts of consumer credit outstanding gathered from lenders and reported in these charts do not say anything about the distribution of the credit among the population, which is only available from surveys of consumers. To meet this need, the Survey Research Center of the University of Michigan began its Surveys of Consumer Finances in 1946, sponsored over the decades mostly by the Federal Reserve. The surveys were annual until 1970, periodic until 1989, and more recently have settled into a three-year frequency (as indicated earlier, since 1992 the National Opinion Research Center of the University of Chicago has taken over the data collection). After each survey, the Federal Reserve staff undertakes substantial efforts to prepare the dataset involving data editing, studying and eliminating discrepancies, estimating missing information statistically, and producing the final dataset for analytical use. The agency staff then makes it publicly available electronically. All this means that the final dataset is not available for analysis for a year or more after the survey, unlike the lender surveys that produce the familiar monthly statistical reports by provider groups widely reported in the financial press.

The Surveys of Consumer Finances show that credit use is widespread through the domestic population. The surveys also show that the portion of users has grown over time. Evidence over seven decades of the surveys demonstrates how the slow long-term rise in the debt-to-income ratio noted earlier is associated with greater inclusion within the credit system. As income and wealth have increased over time, and as lenders have grown in experience with credit granting (and creditors have employed new technologies for credit evaluation), the portion of the public using credit has increased. Since passage in 1974 and amendment in 1976, the Equal Credit Opportunity Act has made illegal any creditor unwillingness to deny inclusion on a list of prohibited bases.

Most observers agree that greater credit access and inclusion within the system is a good thing. Credit access provides many benefits to individuals (discussed further in Chapter 3), which leads to demand for credit. Evidence of widespread inclusion shows that credit supply to them is extensive as well. It is important to note that benefits of credit use, and therefore advantages of inclusion, extend even to younger and lower-income consumers and to older borrowers. It follows that if many individuals benefit from access and inclusion, then so does society as a whole.

It also appears that there has been greater cultural acceptance of credit use over time. No longer is credit use for household purposes as generally frowned upon as in the Victorian period. Some still argue against using consumer credit, but this view is much less widespread than in the past. There also still are issues of blame that arise when some individuals take on too much debt relative to ability to repay comfortably or if something in their lives goes wrong (like unemployment) after taking on the debt. Nonetheless, consumer credit use today also is generally regarded as culturally acceptable and recognized as useful, and sometimes even critical, much more than in the past. More significantly, today its importance for wealth building is also much better understood. As indicated, underlying reasons for credit use are discussed further in the following chapter.[17]

The surveys illustrate that growing inclusion within the system (sometimes also referred to as "debt widening") actually is not new in recent decades; much of it took place in the years immediately after World War II until about 1963 (see Table 2-2). Comparison of survey results show that, in 1951, about 32 percent of American households (including single-person households) were using consumer installment credit, a credit definition that included in those days only nonrevolving consumer credit and not revolving consumer credit that came later (first line of Table 2-2). This was up from a very low, but unrecorded, proportion in 1945, reflecting wartime restrictions on both production and financing. The proportion of households using closed-end consumer installment credit rose to about 50 percent by 1963 and has remained within the range of 41-50 percent since then (first line of Table 2-2).[18]

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[17]For discussion of changing cultural acceptance of consumer credit over time *see* LENDOL C. CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT, op. cit.

[18]Rather than using any data tables from other sources, the tables here using data from the Surveys of Consumer Finances were recalculated from the original source data by Durkin, Elliehausen, Staten, and Zywicki and updated to 2019 by the Taskforce in order to ensure, as far as possible, comparability of conception and definition of variables over time. For this reason, the data tables here may show some small differences from otherwise apparently comparable tables in other analyses using the same survey data. For example, the tables here always define credit for mobile homes as consumer credit and not mortgage credit (since mobile homes are not real property and credit to purchase them is consumer credit in the Federal Reserve Board's statistical series). But such credit may not always be considered consumer credit instead of mortgage credit by other analysts (since it is housing related) and other analysts may prefer to keep mobile home credit with the rest of housing-related debt. There also may be other slight definitional differences between these and tables in other sources, although all such statistical differences are small. The definitions of consumer credit employed here follow Federal Reserve usage, as noted in Chapter 1.

TABLE 2-2: PROPORTIONS OF HOUSEHOLDS USING CREDIT, 1951-2019, IN PERCENT

Type of Credit	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
Closed-end Installment Credit	32	45	50	49	49	41	44	45	44	41	47	50	49
Credit Card With Revolving Balance[a]				22	34	37	40	47	44	46	39	44	55
Notes: Have Any Credit Card[a]				51	63	65	70	74	76	73	68	71	79
Have Bank-type Credit Card				16	38	43	56	66	73	70	64	71	75
Any Consumer Credit[b]	46	53	59	54	61	61	62	64	63	66	62	66	67
Mortgage Credit[c]	20	24	32	35	40	39	38	39	42	46	41	40	40
Consumer Credit or Mortgage Credit	53	62	67	64	70	69	70	72	73	75	73	75	75

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

[a]Cardholders with a balance remaining after the most recent payment. In 1995-2001, includes a few respondents with open-end retail revolving credit accounts not necessarily evidenced by a plastic credit card.

[b]Closed-end installment credit, open-end installment credit (including credit card accounts and unsecured lines of credit), and noninstallment credit (excluding credit for business or investment purposes).

[c]Includes|home equity credit and home equity lines of credit with a balance outstanding.

Beginning in 1970, survey changes made it possible to provide more detail on use of credit cards. Most credit cards in 1970 were issued by retail stores and gasoline companies for use only at their own outlets. Many of these issuers originally provided only charge cards where payment of the bill in full was due shortly after receipt, and the amounts of credit outstanding were counted within noninstallment credit at the time. But attaching a revolving credit feature to these cards was rapidly becoming more popular by 1970.

Even more important for consumer credit markets in the long run, three-party cards such as MasterCard and Visa (then known as Master Charge and BankAmericard) began to become widely available from banks in the late 1960s and eventually could be used almost anywhere. Originally issued only by commercial banking organizations, these cards are sometimes still called bank-type credit cards, although other financial institutions including savings institutions, credit unions, and others now also issue them. (The first three-party card – consumer, merchant, and financial institution – was the Diners Club Card in the early 1950s. For many years, it remained a charge card, although it eventually added a revolving-credit feature.)

Bank-type cards were in the pockets and purses of only 16 percent of households in 1970. The proportion grew to 73 percent in 2001 before falling off slightly afterward (including 64 percent measured in 2013 after the sharp recession earlier in the decade (second line of Table 2-2)). As indicated earlier, over these decades credit cards have taken over much of the work of routine extension of consumer credit for many household purposes, in addition to their role in substituting for cash and checks in many instances. Much of previous consumer credit for appliances and home repairs that in past decades would have involved the credit department of the retailer and sale of the credit contract to a finance company is now handled much more conveniently through the prearranged credit line of a revolving credit card account. Thus, much of the growth in credit-card credit since the 1960s is really a substitution due to technological change rather than a whole new area of credit use.[19]

Including household who have remaining revolving balances on credit card accounts after making their monthly payment (line 2) within the definition of consumer-credit users raises the total proportion of consumer credit-using households. The proportion increased from 46 percent in 1951 and 53 percent in 1956 in the early postwar period, when consumer credit use grew most rapidly to around 60 percent in the half-century 1963-2013 (fifth line of Table 2-2). Consumer-credit users reached about two-thirds (66 percent) in the 2007 and 2016 measurements.

2.4.1 Consumer Credit Use According to Income and Age

Considering inclusion further, the surveys also permit examination of trends in debt use within population segments. Sometimes the view is heard that that consumer credit use is a low-income or lower-middle-income phenomenon, particularly among younger consumers. Actually, the surveys show that low-income, middle-income, and younger consumers have always been users of consumer credit, but that credit use over time has also expanded in all income and age groups.

To look at the use of consumer credit by income level, household respondents to each of the Surveys of Consumer Finances illustrated in Table 2-2 were arrayed according to income and then placed into one of five groups of equal size (quintiles) from lowest to highest income (see Table 2-3). Looking at income quintiles this way frees the discussion from the issue how the definition of "low income" or "high income" might change over time due either to inflation or economic growth. In each year, the lowest income quintile, for example, includes the fifth of the surveyed population with the lowest incomes and the other income quintiles consist of the respective other fifths of the income distribution.

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[19]A research paper by Elliehausen and Hannon showed that this substitution can also go the other way when new constraints arise in the extension of credit on card accounts. Following the sharp recession of 2008-9 and implementation of new Federal restrictions on credit-card management and pricing around the same time, card holding in the lowest-income quintile declined and finance company lending increased. *See* Gregory Elliehausen and Simona M. Hannon, *The Credit Card Act and Consumer Finance Company Lending*, Journal of Financial Intermediation, 34, 109 (2016).

TABLE 2-3: PROPORTIONS OF HOUSEHOLDS USING CONSUMER RELATED CREDIT BY INCOME GROUP, 1951-2019, IN PERCENT

	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
Consumer Credit[a]													
Income quintile													
Lowest	24	37	45	26	38	38	43	44	44	45	45	51	47
Second lowest	41	57	58	49	57	53	52	60	62	59	59	63	66
Middle	56	59	67	65	68	69	69	70	71	76	71	73	75
Second highest	55	61	69	70	73	75	78	78	73	80	72	76	79
Highest	52	52	59	57	71	72	68	70	62	68	65	66	66
All	46	53	59	54	61	61	62	64	63	66	62	66	67
Any Credit (Consumer Credit or Mortgage Credit)													
Income quintile													
Lowest	29	40	46	30	44	42	45	47	47	50	50	56	51
Second lowest	46	61	64	56	62	58	58	66	68	66	65	68	72
Middle	63	67	74	75	76	76	76	77	81	83	79	82	81
Second highest	64	70	78	81	84	84	85	86	84	90	86	87	88
Highest	63	71	75	79	85	87	86	86	86	87	84	83	85
All	53	62	67	64	70	69	70	72	73	75	73	75	75

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

[a]Closed-end installment credit, open-end installment credit (including credit card accounts), and noninstallment credit (excluding credit for business or financial investment purposes).

Table 2-3 shows the proportion of each income quintile with some kind of consumer credit outstanding at the time of the survey. (This includes closed or open-end installment credit in later years and non-installment credit in earlier times) for each of the survey years illustrated in the previous table. The following table (Table 2-4) then measures the proportion of households with these kinds of credit outstanding among population age groups arrayed from the youngest respondents to the oldest.

TABLE 2-4: PROPORTIONS OF HOUSEHOLDS USING CONSUMER-RELATED CREDIT BY AGE GROUP OF FAMILY HEAD, 1951-2019, IN PERCENT

	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
Consumer Credit[a]													
Age group													
Under 35	54	71	76	70	77	74	74	78	76	76	72	76	74
35-44	61	60	72	67	78	78	78	78	74	72	73	77	76
45-54	45	54	62	60	69	70	71	72	68	72	68	74	76
55-64	34	42	45	42	54	55	53	59	58	66	62	61	66
65-74[b]	16	19	26	16	26	29	38	41	42	51	50	57	56
75 and over				9	13	13	17	22	23	23	31	36	40
All	46	53	59	54	61	61	62	64	63	66	62	66	67
Any Credit (Consumer Credit or Mortgage Credit)													
Age group													
Under 35	59	76	81	76	82	79	78	82	81	82	76	80	78
35-44	69	74	82	83	90	87	88	85	87	85	84	86	86
45-54	54	63	72	74	82	81	83	83	83	85	82	84	84
55-64	42	52	53	51	65	66	65	73	73	80	75	75	76
65-74[b]	23	25	33	27	34	36	47	51	54	63	64	68	68
75 and over				14	13	17	20	26	28	30	35	47	50
All	53	62	67	64	70	69	70	72	73	75	73	75	75

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

[a]Closed-end installment credit, open-end installment credit (including credit card accounts), and noninstallment credit (excluding credit for business or investment purposes).

[b]In 1951, 1956, and 1963, 65 and over.

These tables show growing inclusion in all income and age segments 1951-2016. Among income groups, the greatest relative growth in frequency of credit use occurred in the lowest income quintiles 1951-1963; since then, growth in the credit-using population has been moderate in all income groups (upper panel of Table 2-3).[20] Each of the three highest income groupings registered half or more of their members as consumer-credit users in as long ago as 1951 (lines 3-5 of the upper panel of Table 2-3), and the proportion in the third and fourth quintiles reached two-thirds by 1963 (lines 3-4). By 2016, half or more of all income groups were included in credit users and the proportion reached about three-quarters in the third and fourth income quintiles.

Looking at age groups, over the decades the Surveys of Consumer Finances have indicated consumer-credit use shows a life-cycle effect. The NCCF noted this in 1972 (P. 12):

The frequency of installment credit use in relation to age of the family head is, of course, intimately related to the level of income and stage in the life cycle characteristic of that age.

[20]There is a drop in credit use recorded by the 1970 survey among the lowest income segments. This may reflect that 1970 was the only recession year among the survey years in the table. The 2010 survey followed the end of a sharp recession by about six months, and it also shows a general drop in credit use although not in the lowest income quintile (not in table, *see* DURKIN, ELLIEHAUSEN, STATEN, AND ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY, op. cit., p. 72).

Those in the younger age groups ... used installment credit most frequently. A significant decline in the frequency of use did not occur until after age 55.

The profile that emerges is that the consumer most likely to acquire goods and services is young, married, with children at home, and with family income between $7,500 and $15,000 [Note: These were middle-class amounts in 1972.] The stage in life cycle of the family appears to be the most influential in determining frequency of use, while the level of income probably has the greatest influence on the quantity of debt and the quality of the goods and services acquired.

Within age groups, consumer credit use has always been most prevalent among younger consumers. It has long been understood that use of credit is strongly influenced by stage of life cycle, and in the next chapter we will discuss this further. Households headed by younger individuals, for example, are more likely below their long-term average lifetime income level. They also are bearing the costs of acquiring housing and household durable goods, rearing and educating children, etc., and so they are willing to use credit knowing their ability to repay debts that finance these activities likely will rise. Consequently, it is not especially surprising that more than three-fifths of households with heads younger than 45 were consumer credit users in the mid-1950s, and this proportion rose to three-quarters in 1977 and has remained around that level since then (lines 1-2 of the upper panel of Table 2-4).

In contrast, households near or past retirement may not have as many such needs, and they may have accumulated more liquid savings and not need to use credit as often. This life cycle effect is also visible in Table 2-4, although the greatest growth of credit use in percentage terms occurred among older consumers. The proportion of those using consumer credit in the 55-64 age bracket rose substantially over these years, to about three-fifths by 1995 (line 4 of the upper panel). Furthermore, only about one-fifth of households with heads over 65 were consumer-credit users in the mid-1950s, but this proportion has risen over time (lines 5-6). Thus, along with population growth, it seems that an aging population, combined with a higher proportion of older consumers who still use consumer credit, accounts for at least some of the increase in consumer credit outstanding in recent decades. Extremely low interest rates on such things as new car loans in recent years probably had something to do with this trend. For creditworthy older consumers, why use reserves or assets that can be made tax-deferred through IRAs rather than inexpensive credit? Growth of consumer credit use among older consumers is an area for further research.

2.4.2 Shares of Credit Outstanding

Cross-section surveys also permit calculation of the share of total debt held by various groups of consumers. The next two tables contain calculated shares of selected kinds of debt outstanding owed by consumers segmented first by income (Table 2-5) and then by age (Table 2-6). Results of this effort turn out to be revealing and maybe a bit surprising.

TABLE 2-5: SHARES OF KINDS OF CONSUMER-RELATED DEBT OUTSTANDING BY INCOME GROUPS, 1951-2019, IN PERCENT

	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
Closed-end Consumer Installment Credit													
Income quintile													
Lowest	7	6	6	3	5	4	4	7	8	8	10	9	8
Second lowest	14	12	15	16	13	12	9	13	15	12	13	13	14
Middle	22	23	25	24	23	19	22	22	21	22	18	20	22
Second highest	27	30	26	31	27	27	34	28	28	30	26	28	29
Highest	31	29	27	27	31	37	31	30	29	29	32	30	27
All	100	100	100	100	100	100	100	100	100	100	100	100	100
Revolving Balances on Any Credit Card													
Income quintile													
Lowest				2	4	4	2	7	7	6	5	6	8
Second lowest				10	12	10	9	15	13	9	12	13	16
Middle				24	19	20	21	20	22	18	21	17	18
Second highest				35	35	30	30	24	26	32	27	28	29
Highest				30	31	36	38	34	32	34	34	35	29
All				100	100	100	100	100	100	100	100	100	100
Consumer Credit[a]													
Income quintile													
Lowest	6	10	8	3	5	7	5	7	8	9	10	9	8
Second lowest	14	14	14	15	13	12	10	13	15	11	14	14	14
Middle	23	22	25	24	22	18	22	21	21	20	19	19	21
Second highest	27	25	25	31	28	25	32	27	27	30	26	28	28
Highest	31	29	28	27	32	38	31	31	29	29	32	30	28
All	100	100	100	100	100	100	100	100	100	100	100	100	100
Mortgage Credit													
Income quintile													
Lowest	3	2	2	2	3	3	1	2	2	3	3	3	3
Second lowest	8	5	7	7	7	6	5	7	5	5	6	6	6
Middle	17	16	15	17	17	12	12	12	14	15	12	12	12
Second highest	28	26	31	31	28	25	26	26	24	26	24	24	24
Highest	44	51	45	43	44	54	56	53	54	51	55	55	55
All	100	100	100	100	100	100	100	100	100	100	100	100	100
Any Credit (Consumer or Mortgage)													
Income quintile													
Lowest	4	4	3	2	4	4	2	3	3	4	4	4	4
Second lowest	9	7	8	8	8	7	6	8	7	6	8	8	8
Middle	18	17	17	18	18	13	14	14	15	15	13	14	14
Second highest	28	26	30	31	28	25	27	26	25	27	24	25	25
Highest	42	46	42	40	42	51	51	49	50	48	51	49	49
All	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

[a]Closed-end installment credit, open-end installment credit (including credit card accounts), and noninstallment credit (excluding credit for business or investment purposes).

Columns may not add to totals because of rounding.

TABLE 2-6: SHARES OF KINDS OF CONSUMER-RELATED DEBT OUTSTANDING BY AGE GROUPS OF FAMILY HEAD, 1951-2019, IN PERCENT

Table 2-6. Shares of Kinds of Consumer-Related Debt Outstanding by Age Groups of Family Head, 1951-2019, in Percent

	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
Closed-end Consumer Installment Credit													
Age group													
Under 35	33	42	38	46	41	37	31	35	32	35	32	30	30
35-44	33	31	28	21	23	27	31	28	32	22	25	25	25
45-54	21	18	22	22	20	21	22	24	21	23	20	21	21
55-64	9	8	9	10	13	12	10	8	10	14	15	15	14
65-74[a]	4	2	5	1	2	3	4	3	3	4	5	6	7
75 and over				0	1	0	1	1	1	1	2	3	3
All	100	100	100	100	100	100	100	100	100	100	100	100	100
Revolving Balances on Any Credit Card													
Age group													
Under 35				44	35	29	32	27	25	16	12	14	13
35-44				25	23	30	29	29	28	23	20	19	18
45-54				21	27	20	21	26	24	27	23	27	24
55-64				9	11	16	11	11	12	22	25	21	21
65-74[a]				1	3	4	6	5	9	10	13	13	16
75 and over				0	0	1	1	1	2	2	7	6	9
All				100	100	100	100	100	100	100	100	100	100
Consumer Credit[b]													
Age group													
Under 35	34	36	37	45	40	35	32	33	30	30	29	28	27
35-44	32	28	27	21	24	26	31	28	31	22	24	24	25
45-54	21	20	22	22	20	20	21	25	22	24	21	22	21
55-64	10	10	9	10	12	14	10	9	11	17	17	15	15
65-74[a]	3	5	5	1	2	3	4	4	5	6	7	7	8
75 and over				0	1	1	2	1	1	1	3	3	4
All	100	100	100	100	100	100	100	100	100	100	100	100	100
Mortgage Credit													
Age group													
Under 35	30	31	27	29	38	29	29	20	18	19	13	12	14
35-44	33	39	36	36	30	34	38	34	32	27	26	25	27
45-54	23	18	25	24	20	20	19	29	30	28	27	28	25
55-64	10	8	8	7	9	12	11	12	13	18	21	21	19
65-74[a]	3	3	3	3	2	3	3	4	6	7	10	10	10
75 and over				0	0	0	1	1	1	1	3	4	4
All	100	100	100	100	100	100	100	100	100	100	100	100	100
Any Credit (Consumer or Mortgage)													
Age group													
Under 35	31	33	29	32	38	30	30	23	20	21	16	16	17
35-44	33	37	35	34	29	33	36	33	32	26	26	25	26
45-54	23	19	25	23	20	20	19	28	29	27	26	26	24
55-64	10	8	8	8	10	13	11	12	12	18	20	20	18
65-74[a]	3	4	3	3	2	3	3	4	6	7	10	9	18
75 and over				0	0	0	1	1	1	1	3	4	4
All	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

[a]In 1956 and 1963, 65 and over.

[b]Closed-end installment credit, open-end installment credit (including credit card accounts), and noninstallment credit (excluding credit for business or investment purposes).

The central message from the distribution of debt shares measured by the cross-section surveys is stability over time rather than dramatic change; there have been inclusion and outstanding consumer and other credit increases in all income and age groups, leaving the shares quite similar over time. Focusing on consumer credit, the third panel of Table 2-5, shows that the

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upper two income quintiles owed 58 percent of consumer credit outstanding in 1951, exactly the same proportion as in 2016. It must be kept in mind, of course, that some of this pattern is produced by keeping the sizes of the income groups the same (quintiles). If the group sizes were allowed to change over time to, say, groups representing "low income" versus "middle class" or "comfortable," the amount of debt owed by the latter would undoubtedly rise as the group becomes larger due to increasing income and wealth among the population as a whole over time.

By age, where the size of the groupings is not static, the story is a bit different. Younger families have always been large users of credit, but there has been a gradual shift of the share owed toward older users over the decades. Households classified as headed by individuals under age 45 have been and remain the largest users of consumer credit, but these households have lost share since 1951 (lines 1-2 of the third panel of Table 2-5). Households with heads over age 45 have increased their shares of installment credit owed, presumably in part because the population has aged and more individuals are in the upper age groups now. Some of them may also consider debt less expensive and more acceptable now than their counterparts did years ago. As the share of older consumers has increased, the share of others necessarily has decreased.

Balances owed specifically on credit cards definitely show an aging effect (second panel of Table 2-1). In 1970, when credit cards with a revolving credit feature were relatively new, the youngest households owed 44 percent of the card debt (line 1). This probably represents the ages-old phenomenon in which the young are more willing to try new things. By 2016, when the older cohort surveyed that year had literally grown up using credit cards, the share of card debt owed by households in the youngest age grouping had fallen by about two-thirds to 14 percent. This decline may also result from some difficulties that younger consumers may have in acquiring credit cards in recent years. The bulk of the offsetting increases in share were among households with heads over the age of 55.

3. Demand for consumer credit

Previous chapters showed that credit use by individuals is as old as recorded history, and its regulation is just as old, but credit today labeled "consumer credit" became widespread domestically only in the 20th century and especially after World War II. The National Commission on Consumer Finance (NCCF) undertook its review of consumer credit conditions 50 years after modernization of consumer credit began in the 1920s, and full maturation had taken place in the early postwar era. At the outset of the 1970s, the NCCF produced a list of recommendations for updating existing credit processes and regulations to help consumers, the relevant institutions, and the legal environment work better together.

The NCCF did not spend a great deal of time in its 1972 *Report* discussing underlying individual economic motivations for consumer credit use, known in economics as credit demand. Apparently, the NCCF believed that by this time the reasons were fairly obvious. The NCCF found that some credit use was by "necessitous" borrowers down on their luck (and often without much discretionary income—i.e., often poor), but most modern consumer credit use was much more mainstream. The NCCF's *Report* reflected the economic theory of consumer credit that had developed during the credit-modernization period, and it recorded the empirical evidence.

Serious economic study of consumer credit began a century ago, around the time of the beginnings of the "modern period" of credit use in the 1920s. To preview the discussion in the current chapter, at that time economists determined that consumer credit was more than a means of merely advancing the pleasures of household consumption; rather, it supported household capital formation.

There are two major benefits from encouraging capital formation through credit use: First, credit use facilitates purchase of goods and services such as housing, vehicles, appliances, home repairs, and education that provide a return over time from their services; second, credit use enables consumers to adjust consumption patterns over time including over their entire life cycle to a preferred pattern. Credit use enables purchases like housing and durable goods and services at younger ages when they provide high rates of return for those who have not yet acquired such assets. Necessary saving can take place through repayments when incomes have risen. This provides a clear life-cycle effect in credit use where it is most frequently used by the young and use fades a bit with aging. To economists, this is known as a life-cycle effect.

Empirical evidence shows that most consumer credit use arises with household spending to acquire capital goods that provide benefits over time: acquisition of consumer durable goods and services like transportation assets (vehicles), appliances and furniture, home repairs and modernization, substantial hobby and recreation items, higher education, and mitigation of emergencies. Purchases of this kind involve more than merely current consumption. Instead, they are precisely the kinds of purchases that provide ongoing household services producing additional future benefits, not merely shifting consumption from the future to the present as commonly believed in the past. Consumer investments provide a return in preferred consumption over time that can easily exceed the cost of the credit used in acquisition—investments that provide a positive return amount to household capital. They are analogous to industrial capital assets, and are wealth and welfare enhancing.

There is a visible life-cycle effect in the purchase of such assets and the accompanying use of consumer credit: Credit use is more frequent among younger consumers, as discussed in Chapter 2. This is the time in the life cycle when asset holdings and household capital typically are low and the rate of return upon acquiring them is high. It also is the time when ready credit availability likely is lowest due to family incomes that have not yet grown, and families have not yet demonstrated to potential lenders the ability to manage credit use successfully. High return and low credit availability in such situations explain why credit demand can exceed supply from mainstream suppliers and how some households at certain times are willing to use higher-cost alternative credit products, even such forms as payday loans discussed further in Chapter 5.

As households mature, they typically reduce debt use gradually and often transition from borrowing to lending, investing funds by lending to banks and other financial intermediaries such as insurance companies and pension providers (including IRA trustees) through various savings products. These institutions then lend the funds to businesses, governments, and other consumers. The process of lending to institutions to lend to others is conventionally called "saving," but it should be recognized that it is simply another way in which households make investments that generate a positive return. In this case, the return is through interest payments, life insurance protections, pensions, and other benefits of savings products received from the institutions.

Empirical studies over many decades have confirmed this simple but powerful neoclassical economic model that the primary use of consumer credit by most families is to make productive investments rationally that generate a positive return over time. In this sense, most consumer credit usage is similar to the reasons businesses use credit. This chapter reviews the neoclassical model of consumer demand and the empirical evidence that has validated it over time. The chapter then discusses behavioral economics approaches to demand for consumer financial services and especially consumer credit, a novel theory that questions the neoclassical consensus that has dominated the field since its inception a century ago.

3.1 Reasons for Credit Use

The NCCF was aware of the economic theory and evidence that had developed, which was by no means new even in its time. Concerning reasons for credit use, the NCCF stated in its *Report* (page 5): "The reasons for this increased use of consumer credit may be found in the natural adaptation of consumer and business changes to changes in the ability and willingness of consumers to incur debt, as well as to a continued shift toward the ownership of assets." In the next few paragraphs, the NCCF mentioned a number of factors. They included increasing and more stable household incomes in the postwar period, increased urbanization of the population, changing population age distribution toward younger families, more women in the workplace necessitating changes at home, and enhanced willingness of creditors to lend. The NCCF also discussed trends in the sale of household durable goods and then closed this section by returning to the importance of increased asset ownership (page 6):

The shift to asset ownership also reflects a decision by consumers to substitute the use of consumer-owned capital goods for the use of commercially owned capital goods. Thus, the purchase of an automobile substituted, perhaps unfortunately, for daily fares on street cars and buses, the home washing machine and dryer for payments at the laundromat, and the television set for the admission price to movies and other forms of entertainment. Even if the auto or appliance were purchased on credit, the monthly installments paid for it over a much shorter interval than the period of time over which services were received. In addition, quite often consumers also gained significant returns on their investment.

These motivations are intuitive as well as consistent with economic theory and empirical evidence. By itself, however, acquisition of investment assets (or satisfying necessitous situations) is not the complete answer to the question of underlying economic motivation leading to consumer-credit use. There actually is more to the story. As indicated, economists have thought about the essentials of this motivation for more than a century.[1]

[1] For the early development of theory in this area, *see* IRVING FISHER, THE RATE OF INTEREST: ITS NATURE, DETERMINATION, AND RELATION TO ECONOMIC PHENOMENA (1907); *see also* IRVING FISHER, THE RATE OF INTEREST (1930), *and* EDWIN R. A. SELIGMAN, THE ECONOMICS OF INSTALLMENT SELLING: A STUDY IN CONSUMERS' CREDIT (1927, two volumes). The foundational economics is discussed in considerably more detail than here in THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, and TODD J. ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY (2014); a*nd GREGORY ELLIEHAUSEN, Behavioral Economics, Financial Literacy, and Consumers' Financial Decisions*, in ALLEN E. BERGER, PHILIP MOLYNEAUX and JOHN O.S. WILSON, THE OXFORD HANDBOOK OF BANKING (2019). For discussion of cultural aspects of development of consumer credit in the twentieth century and its institutions, see LENDOL C. CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT (1999).

For descriptive purposes, it is common to say that consumers use consumer credit for such and such a purpose, most notably for purchase of costly assets. Nonetheless, a little reflection quickly shows that buying autos, household repairs and furnishings, major hobby items, and education is only part of the fundamental economic behavior that gives rise to these classifications of debt. There is another part.

Rather, it is useful to recall that a significant component of the underlying, basic economic demand motivation for consumer credit use is the desire by consumers to change both the size pattern and the timing of their resource inflows and outflows, especially the investment outflows. Credit markets arise to change the lumpiness of the patterns, particularly of the outflows for purchasing housing and durable goods or for necessities, and to bring *household capital investment* transactions forward in time to the present instead of far off in the future.

In more detail, most purchases on credit could be accomplished by accumulating cash first and then buying the item later, but this often is not the time pattern consumers prefer. Significantly, for many goods, accumulating cash first could mean doing without the item or paying for more expensive substitute services for a period that might amount to years, both of which are costly. For instance, delaying purchase of a vehicle while saving enough cash to make a cash purchase means doing without the convenience of available transportation, possibly limiting places to live, and paying for expensive transportation substitutes meanwhile. Not managing some emergency situation could prove even more costly. Waiting to make these asset adjustments is frequently not going to be the preferred option in societies where there is an alternative. The types of credit we observe in the marketplace in large part come about because they are the least costly ways of providing an acceptable alternative.

Specifically, inflows from salaries and wages that comprise the income of most employed workers in a modern economy typically are quite regular for most consumers (even for many hourly workers), and credit offers the opportunity to smooth the outflows. Lumpiness in outflows can occur during the course of the period between paychecks, but it certainly will occur during the course of longer periods like a year, within a particular life-cycle stage, or over a consumer's or family economic unit's whole lifetime.

For example, for many families, expenditures increase during selected seasons like vacation periods, back-to-school time in September, and around the year-end holidays. Then in some years, there also are bigger, investment-type purchases, such as an automobile or a new home. A few years later, there may be need for another auto or a larger home, and later still for college education for children. Purchase of a vacation home or a large recreation item like a boat may take place once or twice in a lifetime. Home repair or modernization may be important at some points. Sometimes there also are emergencies.

Credit facilitates all these transactions by enabling households to use future regular inflows for the saving necessary to pay for lumpy expenditures made today. Consumers have shown that they are willing to pay a price in the form of interest and finance charges for the possibility of changing the time pattern of saving to a preferred one: acquiring the relevant asset and the return advantages it provides now, thereby obviating the need for costly substitutes while undertaking the saving.

This picture of inflow and outflow/expenditure patterns illustrates how it often is not really correct to say that credit arises solely for the purpose of purchasing specific investment items. The purchases could often be made anyway, just on a different schedule. The accumulating (saving) could be done first, although this would also mean postponing the benefits of the investments (or not solving the emergency situation) and paying for substitutes meanwhile, often for a long time, both of which are costly. The correct interpretation is that credit markets arise to increase consumers' overall well-being by changing the time pattern of both saving and expenditure outflows (typically for lumpy, large purchases) to a preferred one.

The classification by usage problem is especially obvious in the example of an individual purchasing a $35,000 automobile or truck on credit but who simultaneously holds $35,000 or more in a savings account, IRA, 529 college savings plan, or some other financial asset. In some significant sense, this individual is not really using credit only to purchase the vehicle. Rather, the underlying motivation for credit use is to avoid some combination of not buying the car or truck now and entailing costs in not being able to undertake transportation, not giving up some other important purchases either, not paying taxes and penalties for liquidating assets held in retirement accounts, and not reducing reserves stored in other financial assets. Risk-averse consumers may well prefer not to reduce their reserves, which are valuable to them, and replacing them is costly. For many individuals, credit availability through good credit standing can also serve as at least a partial substitute for extensive advance and precautionary savings. In other words, credit availability obviates the need to do things consumers think are disadvantageous, like giving up substantial current consumption in order to make large purchases or periodically running down financial reserves, while still matching the pattern of outflows (payments) better to inflows (paychecks).

Certain kinds of credit associated with specific sorts of investment purchases arise because they permit changing the flow pattern in the least costly manner. Credit is often associated with automobile purchase transactions, for example, because the associated expenditure is large and because relatively large amounts of credit at relatively low cost are readily available to those who are willing to offer the auto or truck as collateral for the loan. Such loans are so common that "automobile credit" has become a large industry by itself. Credit generated in the process of making home improvements and buying automobiles, durable goods, and education, and a variety of other transactions including payment of taxes, debt consolidation, etc., are all well-known types of consumer credit. Advertising for each usage is common, and many financial institutions memorialize these distinctions by separate departments and personnel, even separate subsidiaries and companies.

Most official figures of the volumes of credit for many "uses" are no longer assembled by the government's statistical mills, largely for the conceptual reasons mentioned and because of the practical difficulties with collecting necessary data from creditors to generate meaningful statistical aggregates according to consumers' use of the credit.[2] The only practical way to produce an estimate of consumer credit purposes is to design statistically reliable surveys of consumers like the Surveys of Consumer Finances, ask respondents about their credit experiences, and then in some manner extrapolate from their experiences to the broader public using statistical weighting procedures (see Chapter 2 of this Taskforce report for further discussion of the Surveys of Consumer Finances and some findings about credit use).

3.2 Neoclassical Economic Theory of Consumer Credit Demand

Consistent with these ideas and as indicated above, neoclassical economics, sometimes referred to as "mainstream economics," began formal exploration of consumer credit use in the early part of the 20th century. Neoclassical economics soon produced a body of testable hypotheses that have stood the test of time.

As with use and production of other goods and services, underpinnings of neoclassical economics arise from the central concepts of demand and supply. In neoclassical economics, demand for anything arises from its usefulness or "utility." Supply, in turn, depends on production costs and the potential opportunities for gains over production costs (profits) among potential suppliers. Interaction of demand and supply in markets produces exchange at prices reflecting the utility and production-cost characteristics of the products exchanged. Prices tend toward equilibrium where demand equals supply. Competition can lower prices to the lowest level consistent with covering production costs and profitability just sufficient to bring capital into the industry.

[2] In the past, the Federal Reserve collected information on amounts of consumer credit by usage in its monthly survey of credit volume at granting institutions, but the Board discontinued the usage collection decades ago, except for automobile credit and student loans. Before that time, the monthly surveys asked lending institutions to report credit according to whether it was for automobiles, durable goods, home improvement, or other, but even classifying credit into a few broad categories became increasingly difficult with the advent of open-end credit like revolving credit cards where lending institutions knew little or nothing about specific uses of the accounts.

Economists have examined these notions of demand, supply, prices, equilibrium, and competition for decades, even centuries for some products. In these explorations, few areas have a richer history than credit demand and supply. Analysis of credit and credit markets has become a major mainstream area of economics known today as "finance." And so, this chapter looks in further detail at the basic question of the motivations for using consumer credit in the first place, the concept of credit demand in mainstream financial economics.

The next chapter then discusses credit supply, but not before the second part of this chapter moves to some recent ideas about the range of motivations that might influence credit demand. This latter discussion arises from suggestions for possible enrichments to mainstream economics that have arisen from a branch of the field known as behavioral economics. Suggestions from behavioral economics concerning use of financial services and especially credit use have not always been demonstrated empirically, however, as discussed further in the next section.

Today, most close observers of consumer credit find that its demand arises from its usefulness. Much of it clearly serves useful purposes by allowing individuals to purchase and use capital goods and services while simultaneously undertaking the saving to pay for them through loan repayments. For many individuals, this allows a change in timing of capital purchases to a more favorable schedule. Importantly, it also avoids the necessity of purchasing expensive substitutes in the meantime while the saving is taking place. People could take often expensive urban and suburban mass transit to work for years, for instance, while also foregoing the mobility they prefer by saving first rather than using auto loans. Likewise, people could exercise the high-opportunity cost of years with a lesser-paying (and possibly less satisfying) job while saving for college instead of employing a student loan.

The modern formal economics of credit use essentially began with the classic works of Yale University economist Irving Fisher in the early 20th century (Fisher 1907, 1930). Subsequently extended to consumer credit by Seligman, Hirshleifer, and Juster and Shay, Fisher's work provides the basic framework of the neoclassical economic theory of consumer credit use.[3]

The basic idea of the mainstream theoretical explanation for credit demand derived ultimately from Fisher is that individuals have available to them opportunities that provide a desirable future return. Examples include consumer durable asset purchases that provide a return over a

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[3] *See* FISHER, *supra* note 1; *see also* SELIGMAN, *supra* note 1; Jack Hirschleifer, *On the Optimal Investment Decision*, JOURNAL OF POLITICAL ECONOMY, August, 1958; and F. THOMAS JUSTER AND ROBERT P. SHAY, CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION (1964).

future period. Opportunities also include services, like investing in human capital development such as education, and cost-reducing actions that mitigate the effects of emergencies.

These opportunities permit individuals to invest current resources to provide a return over time while saving for the purchase through loan repayments. The optimal amount of investment is undertaken when the rate of return on the next investment (declining as the more promising investments are undertaken earlier) just equals the available interest rate on the next investment (rising as lender risk increases).

Investments that provide a return over time use current resources, however, possibly large amounts of them. If individuals prefer more current consumption than allowed by the remaining resources still available from current income, consumer credit permits them to borrow resources to finance the assets and still maintain preferred levels of current and future consumption through employing future saving to make the repayments. In other words, as individuals undertake the investment process that requires current resources and interferes with current consumption, they can borrow against future income in a way that advances both goals: 1) facilitating household investment with its returns and 2) preferred pattern of consumption.

Development of this theory demonstrated that the optimal investment decision with borrowing opportunities available can involve greater levels of investment and higher returns than otherwise. It also permits a more highly valued intertemporal pattern of consumption than the optimal investment without borrowing opportunities. This important result for consumer credit (discussed first by Seligman in 1927) countered the widespread belief held in the late 19th and early 20th centuries, and still existing today in some quarters, that all or much of consumer credit use is merely profligacy, an attempt to live beyond one's means. (Sometimes the profligacy notion of consumer credit used to be called disparagingly by some economists and other observers the "home economics" theory of consumer credit that saving should always take place first.)

Of course, there are exceptions to this general rule that credit use is not necessarily profligate, as there are to almost any such general statement. It is easy enough to cite examples of individuals who borrow when they probably should not. Some bad outcomes are even predictable in advance when repayment commitments visibly become too large for a satisfactory outcome.

But other bad outcomes from credit use come about because of events that arise only subsequently to the credit decision and were not predictable at the outset. They include credit failures that arise from economic problems such as job loss or other emergencies that reduce or eliminate expected future income. This involves the concept of risk. To limit these situations, creditors themselves have an interest in preventing too much credit expansion: Losses can ensue when credit for any individual becomes too high (even any credit amount greater than zero for some potential borrowers). Creditors guard against such situations by requiring initial equity in assets (through down payments), raising the price of credit as risk increases (higher interest rates), and by limiting credit altogether at some point (credit rationing). They also typically diversify their credit granting by lending to many consumers, not all of whom are likely to have the same emergencies or job losses at the same time.

Most consumers may not fully think about or understand all the components of the credit demand process outlined, but the economic theory derived from Fisher and Seligman is consistent with empirical evidence. Evidence shows that much of consumer credit use comes about in the process of acquiring consumer assets that provide a return over time. Such credit generation includes automotive credit, student loans, durable goods and large recreational goods credit, and credit involving home repairs and modernization. All these involve larger purchases that provide a return over time with payment patterns that do not eliminate current consumption either.

Another component of credit generation involves mitigating emergencies. Reducing or solving an emergency situation amounts to an investment addressing some cost-causing event, for example an automobile repair need or a health emergency. Eliminating or mitigating the emergency situation without also drastically changing the pattern of current consumption can reduce costs of the emergency, again providing a net positive return over time due to the reduced costs. In the case of a health emergency, the cost reduction (return) versus not fixing the problem could be substantial. In any of these events, focusing only on the cost of the credit without looking at the return is incomplete.

Another empirical finding described in Chapter 2 and mentioned earlier in this chapter is that consumer credit use is more frequent among younger households, especially younger families with children, than among older consumers. Younger households have had less time, and older consumers a longer time, to undertake investments and acquire productive consumer assets including transportation and education. This suggests that the younger consumers will often find remaining investment opportunities with higher returns than older consumers, and younger consumers will often be more willing to borrow to change the pattern of future consumption than their older compatriots. This has led to a life-cycle formulation of the pattern of consumer credit use.

Analysts such as Hirshleifer and Juster and Shay followed in Fisher's and Seligman's footsteps by relaxing some of the theoretical contentions especially relevant to consumer credit in the earliest manifestations of neoclassical finance theory. Hirshleifer explored the situation where rates that consumers can borrow are higher than rates at which they can lend. This led to the conclusion that there are situations when consumers will borrow (rate of return is greater than their borrowing-cost rate), lend (rate of return is less than their lending rate), or do neither (rate of return is between their borrowing rate and lending rate). All these possibilities are observable among differently situated consumers, with the younger ones most likely willing to borrow.

Hirshleifer also explored the implications of rising borrowing rates for consumers as they take on more debt. He concluded that rising rates would reduce the amounts of investments and borrowing as rates rise, but this was consistent with the theory.

Even armchair empiricism suggests the reasonableness of Hirshleifer's conclusions. Many individuals will borrow when presented by attractive opportunities (returns are high), but they are less likely to continue borrowing at higher debt levels because interest rates rise and the protection of current consumption is smaller due to greater repayments. That is, the underlying rates of return become lower due to higher interest rates and repayments. At some point, rates of return no longer exceed borrowing costs, and new investment ceases. Consumers in this situation may neither borrow nor lend, or they may lend in financial markets or through financial institutions. Thus, looking at the household borrowing life cycle—borrowing at a young age, then later limiting borrowing, and eventually switching over more to lending rather than borrowing as rates of return on further investments fall—reflects the situation of many consumers as they age.

Juster and Shay's further extensions of the theory accounted for contract terms that reflect the unwillingness of many consumer lenders to finance the entire cost of consumer durables (i.e., they require down payments) and the existence of specialized lenders offering small amounts of unsecured credit at relatively high interest rates. Their conclusions also are consistent with empirical experience.[4]

Other than credit cards, consumer credit is generally offered on an installment basis, with a repayment schedule of periodic (typically monthly) payments that amortize the loan principal plus interest. Common automobile loans, student loans, and unsecured personal loans take this form. Since the funds for repayment depend on the consumer's uncertain ability to have available future income for payments, lenders commonly limit the amount of credit and adjust repayment terms. On nonrevolving credit, which was the common sort of consumer credit available when Juster and Shay were writing, creditors limited the amount of credit by requiring an initial down payment and a repayment term that was less than the expected economic life of the asset.

[4] This is the same Robert P. Shay of Columbia University who was an economic consultant and, in effect, the Chief Economist of the National Commission on Consumer Finance in 1971-2. F. Thomas Juster was a specialist in human capital formation and was Director of the large Institute for Social Research at the University of Michigan where much of the early research work on psychological and behavioral analysis of credit demand took place around the same time. Both were veterans of the National Bureau of Economic Research (NBER), then in New York and now in Cambridge, Massachusetts, where Shay had been full-time head of the consumer-credit research program in the 1960s and Juster the NBER's president.

In their addition to lending theory, Juster and Shay discussed the possibility that a range of different lenders would develop in the marketplace, based upon their willingness to make riskier loans and charge higher lending rates. Consumers who prefer more credit than primary (low-cost) lenders are willing to offer them, or who are unable to borrow at all from these primary lenders because of risk, may be able to borrow from supplemental lenders who provide additional credit at rates higher than market rates of primary lenders.

Looking at the marketplace today, there are many lenders that provide credit to riskier borrowers than prime borrowers. They include various kinds of subprime lenders such as higher-rate subprime credit card and auto lenders, small-loan companies, and payday lenders (see Chapter 5 for further discussion of them). Supplemental lenders' willingness to extend credit is not unlimited either, however. Consumers may sequentially increase borrowing from additional lenders who are willing to accept greater default risk, but the amounts are limited because no lender will make loans that are certain to default without compensation.[5] This is the basis of the idea of credit rationing (credit rationing is discussed further in Chapter 5).

Much has changed since Juster and Shay were writing in the early 1960s. For instance, advances in information availability through credit reporting agencies (CRAs, widely known as "credit bureaus") and in the technology to manage and analyze large amounts of information have improved ability of creditors to assess risk, making them on balance more willing to lend. Credit reporting through the credit bureaus is now much closer to comprehensive, and new information about individuals with little prior credit experience is under exploration. This has the potential to make overall predictions of future payment performance better still. Development of generic credit scores by the credit bureaus has made statistical evaluation relatively inexpensive and readily available to virtually all lenders. Marketplace competition has also relaxed lenders' equity requirements, as terms to maturity have lengthened for credit advances and down-payment requirements have grown smaller and less frequent. Today, many consumers are more able to finance a greater proportion of household investment through primary (low-rate) lenders like automobile and credit card lenders than in the past. Competition of lenders on a variety of margins including price, availability, and nonprice terms is discussed further in Chapters 6, 7, and 8.

At the same time, there are more secondary (higher-rate) lenders who are willing to lend supplementary amounts beyond that of primary lenders. The NCCF extensively studied the operations, costs, and credit supply of one group, traditional-installment cash lenders (known

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[5] *See also* David S. Bizer and Peter M. DeMarzo, *Sequential Banking*, JOURNAL OF POLITICAL ECONOMY, Vol. 100 (1992).

then as small-loan companies or licensed lenders). Pawnshops existed at the time of the NCCF, but they were uncommon enough in many places that the NCCF barely mentioned them. There also were considerable amounts of consumer credit available from retail stores and dealers, and the NCCF discussed retail-store credit at some length. This latter kind of consumer credit has dwindled greatly over the decades since then with the growth of bank credit cards.

Today, unsecured credit on bank credit cards is more widely available, and many borrowers now use them in the manner that they used unsecured personal loans from finance companies in the past.[6] Competition has extended availability of bank credit cards to many consumers who in the past would have had difficulty qualifying for them. Because bank-card rates are generally lower than other unsecured consumer-credit rates, unsecured credit is now available to more consumers at a lower cost than in the past.

Nonetheless, more pawnshops exist nationwide than at the time of the NCCF, and whole new classes of secondary lenders. They include so-called “payday lenders” and vehicle-title lenders (sometimes called title pawns). Despite better technology and relaxed standards among primary lenders, many individuals still are unable to borrow from low-cost primary lenders who necessarily rely upon secondary lenders or who have no institutional credit available at all, including from secondary lenders.

Chapter 2 of this report showed that interaction between relative benefits and costs of credit has led to a lot of credit use over time. Further, although there is always a lot of discussions about conditions where credit arrangements go wrong, the Surveys of Consumer Finances show that the difficult cases are not in the majority. For instance, in the 2019 survey, 12.3 percent of consumers with any debt indicated being behind in any payments in the previous year but only 4.6 percent behind by 60 days.[7] Undoubtedly, at least some of these accounts paid off and produced a positive outcome, even if slowly. According to the 2019 survey, 2.0 percent of households had declared bankruptcy in the previous five years. This is not to minimize the woe that results for individuals who stumble in using consumer credit, but rather to point out that these cases are not the norm. Taken as a whole, evidence does not suggest an increase in the proportion of distressed borrowers over time, and discussion on Chapter 2 showed that aggregate repayments on consumer credit relative to household income have not increased in the past four decades (see Figure 2-3).

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[6] See Bizer and DeMarzo, 1992, *Sequential Banking*, op. cit. and Dagobert L. Brito and Peter R. Hartley, *Consumer Rationality and Credit Cards*, JOURNAL OF POLITICAL ECONOMY, Vol. 103, 400 (1995).

[7] Neil Bhutta, et al., Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances, FEDERAL RESERVE BULLETIN, September 2020, pp. 28-9.

Measuring rates of return on consumer assets empirically is difficult, in large part because circumstances and needs of credit-using consumers vary widely, and outcomes differ as well. It seems difficult to argue, though, that returns can be anything other than positive for the most part, as theorized by Seligman, Hirshleifer, and Juster and Shay. For consumers themselves, it seems that benefits and costs of credit use are too well known not to be part of consideration and deliberation by credit users in most cases.

It is not especially difficult for consumers to contemplate the potential benefits and costs of credit use. This would be especially true following their initial experiences, and evidence shows that following initial experiences, most consumers continue to use consumer credit over their life cycles. On the cost side, Truth in Lending, passed in 1968 and implemented the following year, was an attempt to simplify cost understanding. Evidence shows that many consumers use this information in the ways they prefer, annual percentage rates (APRs) for larger amounts of credit for longer periods of time, and dollar finance charges for small amounts for shorter periods (see further discussion in Chapters 5 and 7).

Seligman discussed flows of utilities from consumer investment in durable goods as early as 1927, and there have been attempts at direct empirical measurement at least since the time Juster and Shay were writing. For instance, in 1964 Poapst and Waters published their estimates of rates of return on consumer durable goods in the prestigious *Journal of Finance*.[8] Using methodology basically similar to how an investment analyst would study a commercial investment opportunity, they estimated rates of return on an automatic washer and dryer and a television set "for different rates of usage and periods of investment" (page 673). Costs of acquisition and operation were estimated with care, and their equations showed that discounted returns were quite high with reasonable estimates of usage and length of ownership. This would encourage household investment in durable goods using credit under many common circumstances. In their words, "Under such circumstances, the relatively minor variations in consumer-loan interest rates that general monetary policy might be able to produce are not likely to markedly alter the volume of consumer investment" (page 677).

The NCCF was aware of their approach and commissioned professors Dunkelberg and Stephenson of Stanford University Business School to examine it further. [9] In addition to looking at discounted flows of returns and costs together as a financial analyst would do (and

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[8] J. V. Poapst and W. R. Waters, Rates of Return on Consumer Durables, JOURNAL OF FINANCE, December, 1964.

[9] William C. Dunkelberg and James Stephenson, *Durable Goods Ownership and the Rate of Return*, TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, Vol. VI (Washington: Government Printing Office, 1975).

Poapst and Waters did), they explicitly discussed how discounted net returns would also determine the pattern of acquisition of durable goods-namely, those with highest returns would likely be purchased first. They noted that this order could vary substantially among different consumers and households due to preferences and could vary over time, depending upon life-cycle stage. Due to the difficulties of ascertaining individual preferences, Dunkelberg and Stephenson directed their attention first to discounted net returns for a washer and dryer under varying usage conditions, similar to Poapst and Waters.

Dunkelberg and Stephenson then used their own analysis of returns on this particular pair of consumer durable goods as a benchmark. They found (like Poapst and Waters) that returns on an owned washer-dryer could be quite high in many cases and they concluded that returns on some other durable goods must be even higher. Dunkelberg and Stephenson discussed how estimates of rates of return for all durable goods in all circumstances would be difficult to make, but that ownership patterns suggested that many other goods, like refrigerators, were even more important than washers and dryers. If they were more important, this meant they provided even higher discounted returns (data on appliance holdings of families were from the 1967 Survey of Consumer Finances). Dunkelberg and Stephenson acknowledged and discussed the analytical difficulties with this conclusion (such as differences between home owners and renters), but their findings "suggest that such an approach could provide considerable insight into the purchasing behavior of consumers, when combined with data about the cost and availability of capital for various population subgroups" (page 46).

In 2001, Elliehausen and Lawrence provided simple simulations of potential returns on consumer purchases and concluded that they could be welfare enhancing even at payday-loan rates. For discussion, they assumed the example of an individual in need of a $200 payday loan of two weeks for a fee of $30 (APR of 391 percent). But public transportation to employment and additional time spent is also expensive, and under reasonable representations of such incurred costs, it was easy enough to show that the loan to repair the car now would be welfare enhancing on the basis of a financial analyst's calculation of net present value. This would argue for the financial choice to borrow and make the repair.[10]

More recently, analysts at Georgetown University used an approach similar to Poapst and Waters, Dunkelberg and Stephenson, and Elliehausen and Lawrence to rank colleges according

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[10] GREGORY ELLIEHAUSEN AND EDWARD C. LAWRENCE, PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND (Washington: Georgetown University Credit Research Center, Monograph Number 35, 2001).

to graduates' returns from attendance, taking college costs and student-loan costs into account.[11] Although similar in underlying methodology to the earlier studies, the Georgetown study includes simplified description of the underlying approach for those less familiar with financial analysis.

On the first page of the introduction, the authors lay out the essence of the issue about credit: "While much has been written about student debt, not all debt is bad. ... [Students] should consider the net present value (NPV) of their potential earnings, weighing the costs of investing in college now against the potential gains over time." The report goes on to use data from the U.S. Department of Education's College Scorecard, its online database providing information on earnings and debts of attendees at post-secondary schools across the country, to rank these institutions by net return on investment.

The approach in the education study is basically the same as undertaken by Poapst and Waters and by Dunkelberg and Stephenson but with more extensive data. The methodology of any such study requires care in properly stating gains and costs, and all these studies discuss what they have done. The Georgetown study necessarily works with medians, whereas the earlier studies of durable goods looked more at the range of individual outcomes under varying circumstances. The education study provides footnotes to related studies with some differences in their underlying estimating equations (such as employing different discount rates). But for the purposes here, the interesting aspect involves its basic conclusions, even though changing underlying data assumptions could lead to variations in outcomes.

In particular, the conclusions are certainly more favorable and optimistic than the conventional wisdom. It seems a widespread view exists that there is a student-loan debt crisis due to high costs and unfavorable economic outcomes associated with much of higher education today. Certainly, the nature of medians is that they are the center of the range of outcomes. There necessarily are going to be better and worse outcomes than the medians. Some will be much worse (and some much better). But the notable finding of the study is positive net present value of graduating at virtually all the institutions, even given the possibility of taking on debt: "Our findings buttress the idea that college is a worthwhile investment. Moreover, we take the position that college should be seen as a long-term investment" (page 4).

Clearly, investors in such undertakings (students and parents) should consider the potential benefits and costs, as with any investment. They certainly also should consider the likelihood

[11] ANTHONY P. CARNEVALE, BAN CHEAH, AND MARTIN VAN DER WERF, A FIRST TRY AT ROI: RANKING 4500 COLLEGES, Georgetown University Center on Education and the Workforce, 2019. Other studies referenced there have also used the same basic approach.

that the student will finish the course. Even then, this is not to say that an outcome much worse than the median might occur in individual situations. Potential variation in outcomes involves the concept of risk, which is a characteristic of all investments. And certainly, no one ever liked a debt, due to undertaking an investment or not, but this does not mean the investment should not be undertaken.

The message in this section of this report chapter is that development of the neoclassical economic theory of consumer credit suggests a number of important ideas and that empirical evidence is consistent with them:

1. Consumers will be willing to borrow, depending upon rates of return and cost of borrowing available to them. For many households, using debt to finance certain purchases is a rational investment that provides an implicit rate of return that exceeds the cost of finance.

2. Borrowing will tend to be related to household investment undertakings like purchase of durable goods, acquiring human capital, capital improvements and repairs, and emergencies when credit use can be cost saving (or sometimes even life-saving).

3. There would be a life-cycle effect in credit use, since rate of return would be higher in most cases for younger consumers who have not developed a stock of assets and who have limited savings and lower incomes than they typically will have later in life.

4. Since credit involves an unknown future, there are risks in using it.

5. There will be both primary (lower-rate) and supplementary (higher-rate) lenders that develop (in absence of regulation to the contrary, discussed further in Chapter 5).

6. Secondary lenders supplement available credit for some borrowers and provide it to others for whom credit is not available from primary lenders.

7. There is risk in lending, and so there is an absolute lending limit even for secondary lenders due to economic credit rationing. This means that some individuals have only higher-rate credit available or no institutional credit available at all. (Credit rationing is discussed further in Chapter 5.)

Empirical evidence is broadly consistent with these conclusions, but this does not mean these conclusions complete the theory of demand for household credit or that they are not controversial. The next section looks at this question in still more detail.

3.3 Behavioral Theory and Neoclassical Economic Theory of Consumer Credit Demand

The standard neoclassical model of consumer demand for financial services has provided a theoretically robust and empirically well-verified model of consumer behavior for approximately a century, dating back at least to Irving Seligman's two-volume work on theory of consumer demand for installment credit in 1927. That model of consumer behavior provided the conceptual structure for the NCCF Report 50 years later. Today, the neoclassical model of consumer demand continues to provide reliable explanations and predictions of how consumers use financial products, including usage of alternative financial services by rationed consumers.

In recent years, however, some commentators have proposed an alternative model of consumer behavior grounded in the rubric of "behavioral economics" (BE). Assessing the application of behavioral economics with respect to consumer financial behavior is difficult because of ambiguities in BE's claims. The traditional neoclassical approach to consumer demand for financial services offers a clear and determinate theory of consumer behavior and a set of direct, testable implications that can be used to assess the empirical validity of the model. In essence, the model assumes that consumers determine and pursue their own best interests, and tests of the model evaluate outcomes in the context of interests thus defined. The BE approach departs from this theory and replaces it with an inquiry into the quality of consumer preferences. Consequently, its testable implications are not always clear. Of particular concern, BE provides no clear analytical framework for determining which of hundreds of different, often contradictory biases and cognitive flaws might prevent consumers from making welfare-increasing decisions at different times in different contexts. The view of the Taskforce is that although some elements of BE show some potential to provide marginal insights to consumer financial decision making that might eventually be applicable to policy development, especially when determining how to best provide information to aid shopping decisions, BE remains too uncertain as a science and its policy implications too speculative to provide a firm foundation for policy development compared with the longstanding and well-developed neoclassical model of consumer finance.

This section of the report will not provide an exhaustive discussion of BE and its limits. Instead, the discussion here will focus on the unanswered questions of BE that should be addressed before the Consumer Financial Protection Bureau or other consumer protection agencies try to use it as an analytical tool for consumer protection in a fashion that will be likely to improve consumer welfare. Following a brief overview of BE and its sister field of behavioral law and economics (BLE), this section will discuss three unresolved difficulties with relying on BE and BLE as a basis for consumer financial protection policy: (1) questions about BE's economic foundations and the robustness of evidence for various biases, (2) the challenges for BE as a matter of theory in determining which of the hundreds of biases that have been alleged to exist would be relevant to assessing consumer decision making in any given choice context, including the strength of any biases relative to offsetting biases and how widespread those biases are in the population, and (3) the lack of empirical validation for the application of BE-derived hypotheses to explain observed decision making by consumers in financial contexts. Given the current state of knowledge about these issues, there seems to be little reason to believe that abandoning the neoclassical model of consumer finance would result in better consumer financial protection policy.

3.3.1 What is Behavioral Economics, Behavioral Law & Economics, and Consumer Demand for Financial Products

There appears to be no single accepted definition of what constitutes "behavioral economics." Different definitions of the concept have been provided over time with different implications for economic analysis and public policy. The first approach simply recognizes that consumers face limited time, attention, and cognitive capacity, and these psychological constraints are relevant to predicting economic behavior. The second approach pushes further and argues that consumer decision making is riddled with biases and other cognitive limits that lead them to make errors systematically that make them worse off.

1. Behavioral Economics and Psychology

At its most abstract level, BE can be defined as "a method of economic analysis that applies psychological insights into human behavior to explain economic decision making."[12] To the extent that BE simply reflects an effort to apply psychology to the analysis of economic decision making or to model consumer decision making more accurately, there is nothing terribly controversial or novel about it. Beginning in the 1950s and continuing through the next few decades, economist Herbert Simon started to raise questions about the models of individual decision making that implicitly motivated much of the economic research of the era. Simon argued that time and cognitive attention are scarce resources that must be allocated across many different decision making tasks. Because acquiring information requires time and attention, all decisions—including consumer purchasing decisions—will be made with imperfect information.

[12] *See* "behavioral economics" *in* Oxford Languages; *see also* "Behavioral Economics" *in* Investopedia.com, *available in* https://www.investopedia.com/terms/b/behavioraleconomics.asp ("Behavioral Economics is the study of psychology as it relates to the economic decision making processes of individuals and institutions.").

Decision makers will thus be "boundedly rational" instead of fully rational, in that they will always make decisions with less than full information.[13] From this insight, it was but a short extension of the theory to recognize that in a world of scarce time and attention, consumers will collect additional information up to the point where they subjectively believe that the marginal value of acquiring more information is equal to the marginal cost of doing so.[14]

In addition, many consumer decisions invariably include projections about the future. But the future is inherently uncertain. Uncertainty about the future is especially important when a consumer decides whether to use debt to make a purchase. For example, the decision whether to borrow to purchase a home or to attend college requires a projection about the expected return on those investments over time in light of the opportunity cost of alternatives. Taking out any loan involves risk of unexpected financial setback, such as illness or unemployment that could result in making it more difficult than expected to repay the debt; alternatively, an unexpected salary raise or stock market boom makes repayment easier and reduces the risk of nonpayment. Given the long-term implications of many decisions, consumers invariably face uncertainty with respect to any given investment. Moreover, no matter how rational the estimate of time at the point of the transaction might be, it inevitably will be wrong in some cases.

Using psychology to analyze consumer financial habits has been part of the field since its beginning. As early as 1889, Thorstein Veblen's theory of "conspicuous consumption" -that people's spending habits are intended to impress their neighbors-implicitly assumed that consumers would be willing to rely on debt to live above their means if necessary.[15] In his 1912 book *Charge It*, Irving Bacheller complained that access to credit induced people to live extravagant lifestyles that exceeded their actual financial means, leading many to financial ruin.[16] By 1938, in his famous book *The Folly of Instalment Buying*, Roger Babson railed about the predatory nature of consumer installment sales, which he believed seduced people into purchasing unnecessary luxuries—his example was a clothes washing machine—with the promise of easy monthly payments instead of saving up and paying cash.[17] Merchants were

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[13] Herbert A. Simon, Models of Bounded Rationality (MIT Press, 1982).

[14] *See* George J. Stigler, *The Economics of Information*, J. of Pol. Econ. 213 (1961).

[15] Thorsten Veblen, The Theory of the Leisure Class (1889); *see also* Colin Campbell, *Conspicuous Confusion? A Critique of Veblen's Theory of Conspicuous Consumption*, 13 Sociological Theory 37, 41 (1995) (noting that Veblen's theory suggests that people would be "willing to run up a sizable debt in pursuing this goal" of using conspicuous consumption to obtain social status).

[16] Irving Bacheller, Charge It: Or Keeping Up with Harry (Bacheller, Harper & Brothers, 1912).

[17] *See* Roger W. Babson, The Folly of Instalment Buying 8-9 (1938). According to Babson, it was beyond the ability of "housewives to resist [the] temptation" of a new automatic laundry, and their husbands refused to "use the arithmetic" they were "taught in grammar school" or they would have not have yielded to the temptation. *Id.* Although

criticized especially harshly for supposedly preying on women by exploiting their supposed weaker level of psychological self-control (relative to men) and supposedly weaker math skills (again relative to men) to sell them goods on installment credit.[18] Although many of these theories were grounded more in pop psychology than scientific psychology, there is no shortage of voices today that echo sentiments that some groups of consumers are not fully capable of making wise choices for themselves—updated to remove sexist stereotypes about consumer incapacity.

The first comprehensive analysis of financial decision making from the perspective of modern psychology was provided by George Katona of the University of Michigan's Survey Research Center in his 1975 book *Psychological Economics*. Katona's investigation into consumer decision making revealed that in making financial decisions, people acted consistently with the predictions of the bounded rationality model of consumer decision making. Katona found that consumers tended to invest greater resources in planning and search when purchasing expensive durable goods, such as planning for the purchase, extensive search for information, and careful consideration of alternatives before making a purchase.[19] Moreover, consumers tended to invest more time and deliberation when purchasing a product that was especially expensive or important, a new or unfamiliar product, or when they were dissatisfied with a previous purchase.

Because information is costly and cognitive attention is scarce, consumers will always make purchase decisions with limited and imperfect information. As a result, it follows that consumers inevitably will make errors that could have been avoided had they had sufficient time and energy to research and search further. But assuming that consumers in their search activities typically turn first to those sources of information that produce most valuable and reliable sources of information, and later to less useful sources, consumers should, on average, make more correct, welfare-improving decisions than wrong decisions even with limited information. This approach also suggests that when decisions are repeated, consumers should learn from experience and thereby become better at making repeated decisions over time than decisions they make sporadically. In addition, because other consumers are simultaneously engaging in active search and evaluation, the process of trial and error and feedback associated with the market process should generate default rules that are responsive to consumer

little-known today, Babson was legendary during his era as a leading investor, one of the founders of investment theory, and most notably, as one of the few economists who predicted the 1929 stock market crash. Babson was the founder of Babson College

[18] *See* Lendol Calder, Financing the American Dream: A Cultural History of Consumer Credit 166 (2001).

[19] *See* DURKIN, et al., supra note 1.

preferences.[20] The aggregation of experiences of many consumers making choices implicitly provides information to consumers as to the quality of competing providers and the usefulness of different products and services.

In turn, suppliers use advertising and other types of information to reduce the information costs to consumers of learning about those products and to highlight the terms and features of most interest to consumers. Sellers will have an incentive to highlight or nudge consumers toward existing and new products, attributes, and experiences that increase their satisfaction and welfare, thereby building brand loyalty and a positive market reputation.[21] "If, for example, consumers discount future consequences too heavily, sellers of products or services with long-term benefits have incentives to try to make those consequences more vivid and more salient to the consumer. If complex pricing plans are difficult for consumers to understand, firms in competitive markets have incentives to simplify those plans to attract customers."[22] Sellers also have incentives to avoid the problem of "information overload, because it will undermine the message they are trying to convey," and if some consumers are paralyzed by too many choices, some sellers will have the incentive to simplify available options.[23] Sellers also draw on the experiences of many other consumers to suggest new products and services that consumers might not be familiar with.[24] For all these reasons and others, even in a world of costly information, uncertainty, and limited time and attention, consumers in a competitive market should be expected generally to make decisions that are "correct" in the sense that they on

[20] *See* Adam C. Smith and Todd J. Zywicki, *Nudging in an Evolving Marketplace: How Markets Improve Their Own Choice Architecture*, *in* Nudge Theory in Action: Behavioral Design in Policy and Markets 225 (Sherzod Abdukadirov ed., 2016). This ongoing co-evolutionary process of consumer choice and market adaptation has been coined "ecological rationality" by economist Vernon Smith, reflecting the evolutionary and adaptive nature of the iterative process in a mutual process of discovery between consumer choice and market providers. Smith contrasts ecological rationality with constructivist rationality, such as the imposition of "nudge" rules by government central planners based on abstract economic theories instead of the emergent process of market dynamics. *See* Vernon L. Smith, Rationality in Economics: Constructivist and Ecological Forms 94-114 (2007); *see also* F. A. Hayek, *Competition as a Discovery Procedure*, 5 Q. J. Austrian Econ. 9 (2002).

[21] *See* Adam C. Smith and Todd J. Zywicki, *Nudging in an Evolving Marketplace: How Markets Improve Their Own Choice Architecture*, *in* Nudge Theory in Action: Behavioral Design in Policy and Markets 225 (Sherzod Abdukadirov ed., 2016).

[22] J. Howard Beales, *Behavioral Economics and Credit Regulation*, 11 J. L., Econ., and Policy 349, 359(2015).

[23] *See* J. Howard Beales III, *Consumer Protection and Behavioral Economics: To BE or Not to BE?*, 4 Competition Policy International 149, 166 (2008).

[24] *See* Smith and Zywicki, *supra* note 21. For example, as discussed below, current rules regarding enrollment in bank overdraft protection requires consumers to "opt-in" to coverage for ATM and debit card transactions. When initially asked about whether they would choose to opt-in, about half of respondents in one focus group indicated they would not. When prompted as to whether they would opt-in to coverage so as to have it available in case of an emergency, however, half of those who initially said they would not enroll changed their mind and opted-in. *See* ICFMacro, Design and Testing of Overdraft Disclosures: Phase Two at 18-19 (Oct. 12, 2009) (research conducted in collaboration with Board of Governors of Federal Reserve).

average improve their welfare relative to the opportunity, even if their decisions do not appear to be "optimal" as defined by abstract economic principles.

The policy implications of using psychology to understand how consumers make economic decisions are straightforward. Most obvious, consumers develop useful shortcuts and heuristics to reduce information costs and uncertainty. They develop their own rules and habits to maximize their likelihood of being satisfied at lowest cost, and through their own iterative feedback process they typically retain rules that work to solve recurrent problems efficiently and abandon those that do not.[25] For example, consumers generally can rely on the value of a name brand or trademark as a signal of quality in situations where they lack the expertise to evaluate quality attributes directly or for experience goods where consumers will not learn about quality attributes until later.[26] Consumers often will be willing to pay a price premium to purchase from a provider with a quality brand when they believe that paying the premium to receive an implicit assurance of quality will be less-expensive than the risk and cost of trying to ascertain directly the quality attributes of an unbranded alternative. In this sense, relying on brand names as a proxy for quality is a rational response to decision making under conditions of uncertainty and costly information.[27]

Government intervention can also provide a useful role within a framework of bounded rationality to improve the outcomes of consumer decision making. For example, government regulations that mandate disclosure of important product terms and features in a standardized format can reduce consumer shopping costs and facilitate competition, thereby improving the likelihood of beneficial outcomes for consumers.[28] On the other hand, the same psychological constraints of scarce attention, time, and energy place limits on the ability of consumers to process and understand mandated disclosures, and too many mandated disclosures can overwhelm and confuse consumers.[29] In addition, rules that prohibit fraudulent and deceptive communications can reduce cognitive processing costs for consumers by decreasing the prevalence of inaccurate information in the market that consumers will have to wade through to find accurate and useful information.

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[25] *See* Gerd Gigerenzer, *Why Heuristics Work*, 3 Perspectives on Psycholoigcal Science 20 (2008).

[26] *See* discussion in chapters 6 and 7.

[27] *See* Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615 (1981).

[28] *See* Durkin, et al., *supra* note 1, at 129.

[29] *See* Omri Ben-Shahar and Carl E. Schneider, More Than You Wanted to Know: The Failure of Mandated Disclosure (2014).

Nevertheless, despite the incentives for consumers to shop proactively and to collect useful information in a cost-effective manner, and despite their use of sensible information-processing shortcuts, they will nevertheless still make mistakes, either because of a lack of information or because uncertainty makes certain information unknowable at the time of the decision. Governmental policy interventions can help to reduce the frequency and cost of decision errors but cannot eliminate them.

2. Behavioral Economics as the Study of Consumer Biases and Errors

Behavioral economics as it has come to be known and practiced since Simon and Katona, however, has largely abandoned the project of seeking to understand how consumers actually make decisions under conditions of uncertainty. Instead, BE has become a research program of demonstrating and cataloging purported anomalies and biases in human reasoning and behavior. Under this approach, the researcher establishes the "correct" answer derived from some measure (consumer's stated preferences or some stipulated outcome measure) and measures deviations from it and then grades consumers accordingly, often without considering alternative explanations as to whether the deviations may be rational in the real world.[30]

The modern field of BE is typically associated with a series of articles published in the 1970s by Amos Tversky and Daniel Kahneman, in which they purported to show a series of supposed biases and errors in individual psychology and problem solving.[31] Building on this foundation in psychology, economist Richard Thaler applied those concepts to economic decision making to document consumer deviations from the model of unbounded rationality, implicitly suggested by some economists as the model for measuring successful consumer decision making.[32] Although often referred to today as "biases" or "heuristics-and-biases," sometimes BE is simply referred to as concerning itself with the study of individual "irrationality." Although there is no precise definition of what constitutes an individual bias or anomaly, it is estimated that researchers have identified approximately 200 different biases that are said to affect individual decision making.[33] These include purported biases that could be relevant to understanding

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[30] *See* Gerd Gigerenzer, *The Bias Bias in Behavioral Economics*, 5 Rev. of Behavioral Econ. 303, 303-04 (2018).

[31] *See* Amos Tversky and Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 Science 1124 (1973); Amos Tversky and Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 4 Cognitive Psychology 207 (1973); Amos Tversky and Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 Science 453 (1981); *see also* Daniel Kahneman, Thinking, Fast and Slow (2011).

[32] *See* Richard H. Thaler, Misbehaving: The Making of Behavioral Economics (W. W. Norton & Company, 2015).

[33] *See* Jeff Desjardins, *Every Single Cognitive Bias in One Infographic*, VisualCapitalist.com (Sept. 25, 2017), *available in* https://www.visualcapitalist.com/every-single-cognitive-bias/; Wikipedia, *List of Cognitive Biases*, *available in* https://en.wikipedia.org/wiki/List_of_cognitive_biases.

consumer use of financial products, such as framing, loss aversion, mental accounting, and hyperbolic discounting.

BE has primarily developed in a laboratory setting, divorced from consumers' actual real-life decision-making tasks and contexts. Participants in experiments are often asked to perform somewhat arbitrary mental tasks that bear little resemblance to decisions they make in their day-to-day lives and real-world contexts, including financial decision making. Researchers design the experiments and then interpret the results. As a result, the researchers face the challenge of ensuring the laboratory experiment that they design actually tests the intended hypothesis, and then the researcher must understand the subject's state of mind to interpret the results of the experiment. This requires the experimenter somehow posit a "correct" answer to a question that can be compared the answer chosen by the individual being studied, which can be "right" or "wrong."

As a result, a distinct characteristic—and challenge—of BE is that it abandons a fundamental precept of standard economics, the premise of "revealed preference."[34] Originally associated with the work of economist Paul Samuelson, the theory of revealed preference holds that the best evidence of a consumer's actual preferences is the actual purchase and other choices they make.[35] The postulate of revealed preference arises from the subjective nature of consumer preferences and diminishing marginal utility.[36] As a result, consumer preferences vary from person to person and even within the same person in different choice contexts.[37] It is only by making actual choices among available alternatives in a specific context at a specific time that an external observer can ascertain an individual's preferences. In many instances, individuals might not know their true preferences themselves until forced to choose in a particular context.

BE rejects the idea that revealed preferences consistently are the best evidence of an individual's "true" preferences. Instead, it contends that because of various biases and problems of self-

[34] See Joshua D. Wright, The Antitrust/Consumer Protection Paradox: Two Policies at War with Each Other, 121 Yale L. J. 2216 (2012); see also Todd Zywicki, The Behavioral Economics of Fixed-Rate Mortgages (and Other Just-So Stories), 21 Sup. Ct. Econ. Rev. 157, 189-90 (2014).

[35] See Paul A. Samuelson, A Note on the Pure Theory of Consumers' Behaviour, 5 Economica 61 (1938); Paul A. Samuelson, Consumption Theory in Terms of Revealed Preference, 15 Economica 243 (1948).

[36] *See* Carl Menger, Principles of Economics (1871).

[37] *See* Thomas Sowell, Knowledge and Decisions 218 (1980) (("The real problem is that the knowledge needed is knowledge of *subjective patterns of trade-off that are nowhere articulated*, not even to the individual himself. I might *think* that, if faced with the stark prospect of bankruptcy, I would rather sell my automobile than my furniture, or sacrifice the refrigerator rather than the stove, but unless and until such a moment comes I will never *know* even my own trade-offs, much less anybody else's."); James M. Buchanan, Cost and Choice: An Inquiry in Economic Theory (1969).

control, a person's true preferences can deviate from preferences revealed by actual behaviors. More important, BE theory implicitly holds that it is possible to ascertain an individual's true preferences and to determine how revealed preferences, as inferred from the actual choices made under conditions of scarcity, deviate from true preferences.[38]

Although the process by which BE theorists go about ascertaining people's true preferences as opposed to their revealed preferences is somewhat mysterious, they seem to use two mechanisms. First, they look at what people say are their preferences using surveys or choices made in the artificial environment of the economics laboratory. Second, it seems that BE theorists derive propositions they believe to be welfare-maximizing for the average person and then assume those are the preferences for everyone, regardless of their subjective preferences or whether they are value maximizing for them, such that any deviations are considered presumptively irrational.

Under criteria for rationality derived this way, many actual choices made by individuals who believe they are completely rational in that they are consistent with their preferences, resources, and constraints (and visibly would seem to be rational under these conditions) nevertheless could be classified as not rational. For example, many BE theorists claim to have discerned that consumers have a true preference to save more money for retirement than they currently do based on their expressed views in surveys, but because of a variety of supposed cognitive biases, they often fail to carry through on these plans.[39] At the same time, however, an overwhelming number of people also say they would like to work less, borrow less, save for other goals (such as a home, emergency savings, or their children's college education), and spend money on goods and services that would make their lives easier and more comfortable, such as a reliable car, new roof, refrigerator, furniture, rent, or utilities.[40] And, as discussed in Chapter 12, the vast majority of Americans save enough or more than enough for retirement, and of those who do not currently save for retirement are pressed by other financial priorities or saving for other purposes. One survey by a major provider of retirement plans found that roughly 80 percent of employees were participating in the employer's plan, and those who were not participating were

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[38] *See* Richard H. Thaler and Cass R. Sunstein, *Libertarian Paternalism*, 93 Am. Econ. Rev. 175 (2003); John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian, *How are Preferences Revealed?* 82 J. of Public Econ. 1787 (2008).

[39] It is not specified how widespread this deviation between intended and executed plans must be for it to be considered problematic. It is not clear why only those who save too little for retirement might be considered as exhibiting biased decision making whereas those who save too much are not, even though both groups bear costs from their choices.

[40] See Todd J. Zywicki, Do Americans Really Save Too Little and Should We Nudge Them to Save More? The Ethics of Nudging Retirement Savings, 14 Georgetown J. of Law and Public Pol'y 877 (2016).

ineligible, paying down consumer or student-loan debt, saving for some other purpose (such as emergency savings, a home, or college), or were using all their income to meet current needs.[41] By contrast, a trivial minority of those who at any given time are not participating in a retirement plan do so for reasons emphasized by BE, such as not "taking the time to do it"—only 6 percent of the 20 percent of employees who were not participating offered that response, or about 1.2 percent of all employees in the sample.[42] Thus, surveys and games played in a laboratory do not simulate decisions made subject to real-world constraints and opportunity cost in real-world contexts and it is not viable to claim to be identifying an individual's "true" preferences without accounting for the limits of opportunity cost and constraints, including resource constraints.

Surveys and games played in a laboratory do not simulate decisions made subject to real-world contexts, and it is not viable to claim to be identifying an individual's true preferences without accounting for the reality of opportunity cost and constraints. Can economists confidently conclude that it is "irrational" to spend money on a memorable wedding honeymoon today because the "true self" would rather save to have marginally more money to spend when he or she is a 75-year-old widow/widower? Indeed, a nontrivial number of people do not even survive until retirement age; there is a clear survivor bias in asking only those who do survive whether they wish they had saved more money for retirement. The probability that a 30-year-old will die before she or he reaches the age of 70 is 15 percent for women and 20 percent for men.[43] It is a reasonable assumption that had those individuals known they would die before their retirement was reached, their true preferences would have been to increase their consumption while alive instead of deferring consumption until they were deceased.

Even when behavioral economists do not assume they know true preferences, they frequently compare their findings to the optimal choice that a fully informed person facing no costs of information, no costs of decision making, and no uncertainty would make. That, however, assumes away the economic realities that motivated BE in the first place. It offers no useful insights into public policy in particular, any more than the observation that if people were unconstrained by their incomes, they would purchase more Mercedes and fewer Volkswagens.

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[41] Transamerica Center for Retirement Savings, 16th Annual Transamerica Retirement Survey: A Compendium of Findings About American Workers 31 (Aug. 2015), https://www.transamericacenter.org/docs/default-source/resources/center-research/16th-annual/tcrs2015_sr_16th_compendium_of_workers.pdf

[42] Id.

[43] *See* Any Kiersz, *This Is When You're Going to Die*, Business Insider (Mar. 21, 2014), http://www.businessinsider.com/social-security-life-table-charts-2014-3.

Similarly, it is a reasonable assumption that we would all make different decisions if we knew the future with certainty.

3. Behavioral Law & Economics

For current purposes, behavioral law and economics (BLE) can be understood as the effort to apply the supposed insights of BE to implement legal and policy goals.[44] BLE claims that the insights of BE can be applied in specific institutional choice contexts to identify market failures caused by individual cognitive biases and mistakes and to develop corrective policies that will increase consumer welfare. The premise of BLE is that policymakers can (1) predict *which* biases will apply and *how* those biases will manifest themselves in any particular choice context, (2) those biases are *systematic*, and (3) government regulation can improve outcomes.[45]

For example, consider a well-trod BLE hypothesis about the supposed propensity for consumers to overborrow on their credit cards. According to BLE theorists, "many" consumers believe each month that they are going to pay off their outstanding balance at the end of the month but fail to do so, leading them to revolve their debt and pay finance charges. This recurrent pattern of mistakes occurs because consumers supposedly suffer from a variety of cognitive biases, such as "overoptimism" bias, hyperbolic discounting, and others that lead them to overestimate their likelihood of paying off their credit card bill in full each month.[46] In addition to consumers' being mistaken about their propensity to revolve balances on average, consumers' errors are posited to be systematically biased in the sense that consumers are substantially more likely to be overoptimistic about their propensity to pay off their balance each month (i.e., they believe they will pay off the bill and do not) than they are to be underoptimistic (i.e., they believe they are going to revolve balances but do not).

In the context of credit cards, therefore, BLE makes three predictions that distinguish it from standard economics about choice under uncertainty: First, many consumers make mistakes; second, those mistakes are systematically biased toward borrowing too much and saving too little; and third, because of the deep-seated and unconscious nature of these biases, consumers do not learn from their mistakes. Neoclassical economics of decision making under uncertainty argues the opposite: First, Consumers on average make welfare-improving decisions and are more likely to do so as the cost of errors increases; second, errors will be systematically

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[44] *See* Christine Jolls, Cass R. Sunstein, and Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 Stanford L. Rev. 1471 (1998).

[45] These assumptions appear to be implicit in BE as well.

[46] *See* Oren Bar-Gill, *Seduction by Plastic*, 98 NW L. Rev. 1373 (2004).

unbiased; and third, consumers learn from their mistakes and update their choices going forward, and the larger the costs of their mistakes the more likely they are to learn.

One can thus visualize the model of consumer behavior from neoclassical economics as consumers having a distribution of outcomes centered on the "correct" answer, with errors being symmetrical in distribution. To use the example of credit cards, most consumers would be expected to accurately predict their likelihood of revolving their balances each month, with the distribution of errors being systematically unbiased (i.e., consumers are just as likely to underestimate their probability of revolving as to overestimate their probability). The BLE model, by contrast, would predict that the majority of consumers (or at least a sizable and identifiable minority) would err in their expected likelihood of revolving balances at the end of the month and that those errors would be systematically biased (i.e., consumers would be much more likely to be overoptimistic about their likelihood of paying off their balances than to be underoptimistic).[47]

3.3.2 Difficulties with the BE and BLE Models of Consumer Financial Protection

The remainder of this part of the chapter will discuss three challenges to the prospect of BE and BLE emerging as a viable alternative to the traditional economic model of demand for consumer finance that has motivated economic research and policymaking for the past century: (1) Ongoing questions about the robustness and context-dependent nature of many of the supposed biases and anomalies that BE theorists have claimed to have identified in individual decision making; (2) BLE's questionable theoretical foundations with respect to being able to determine and predict which of the nearly 200 biases that have been identified will apply in specific choice contexts, and the direction and magnitude of those influences; and (3) BLE's lack of empirical support to date for its hypotheses about consumers' use of financial products and services.

1. BE's Contested Scientific Foundations

Many of the underlying scientific premises of BE remain highly contested. As BE has matured from a niche field of *ad hoc* anomaly spotting to a more mature field of claimed generalizable insights about human decision making, many of the original claims of BE have become less secure rather than more secure, including growing questions about the existence, robustness, and context-dependent nature of many supposed individual cognitive biases. Indeed, even co-founder Daniel Kahneman has attested to the ongoing reevaluation process of early conclusions,

[47] Empirical analysis of these competing hypotheses is discussed below.

admitting that he "placed too much faith in underpowered studies," of which he was not sufficiently skeptical at the time and which have failed to be replicated by independent researchers.[48]

These problems with BE stem from a variety of sources, including problems in experimental design and the challenges inherent in interpreting raw data from observed laboratory findings by attaching a motivation or bias to explain the finding. Hypotheses are often poorly specified for testing in artificial experimental settings, and alternative hypotheses that might explain the observed behavior are often ignored. Many initially identified biases have come to be recognized as context dependent or contingent on the specific conditions of the experimental design. In other instances, contrary results of some experiments have been ignored in reporting on the claimed overall robustness of the evidence in support of a proffered bias. In many instances, the willingness of BE and BLE scholars to engage in *ad hoc* and *ex post* rationalizations to interpret observed findings as confirming BE hypotheses might be explained by reference to various potential biases, such as confirmation bias and motivated reasoning.[49] Abandoning the theory of revealed preferences as the best evidence of consumers' actual subjective preferences also raises the potential for the observer to inadvertently believe that his or her own preferences are actually the true preferences of the subject.

The inability to replicate leading findings in a variety of scientific fields has given rise to what has been labeled a "replication crisis" or "reproducibility crisis" across the sciences.[50] The replication scandal has hit the field of psychology especially hard, as one 2015 effort found that fewer than half of leading studies published in three psychology journals could be replicated by independent researchers.[51] The problem of replication has not spared behavioral and experimental economics: One effort to replicate the top-line statistical finding from 18 laboratory-experimental papers published in *The American Economic Review* and the

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[48] *See* Ulrich Schimmack, Moritz Heene, and Kamini Kesavan, *Reconstruction of a Train Wreck: How Priming Research Went off the Rails*, Replicability-Index Feb. 2, 2107), *available in* https://replicationindex.com/2017/02/02/reconstruction-of-a-train-wreck-how-priming-research-went-of-the-rails/.

[49] *See* Todd J. Zywicki, *The Behavioral Economics of Behavioral Law & Economics*, 5 Rev. of Behavioral Econ. 439 (2018).

[50] The "replication crisis" can be distinguished from the problem of outright fraud in that has led to the withdrawal of many leading papers, including several research findings that were later withdrawn that BLE scholars have relied on in their own research. *See* Todd Zywicki, *Does the Growing Exposure of Scientific Fraud in Social Psychology have Implications for Behavioral Law & Economics*, The Volokh Conspiracy (Oct. 8, 2012), *available in* http://volokh.com/2012/10/08/does-the-growing-exposure-of-scientific-fraud-in-social-psychology-have-implications-for-behavioral-law-economics/.

[51] *See* Open Science Collaboration, *Estimating the Reproducibility of Psychological Science*, 349 Science 943 (2015) (Issue 6251, August 28, 2015).

Quarterly Journal of Economics between 2011 and 2014 was unable to do so in 40 percent of cases.[52] This replication concern leaves aside the additional difficulty of interpreting those results and their relevance to real-world choice contexts.

Beyond the question of the ability to replicate earlier experimental economics studies lies a larger issue—the contested scientific basis for many of the most important biases that have provided the intellectual foundations of BE. These include such linchpins of BE as the "endowment effect," "loss aversion," and a variety of observed behaviors that are often interpreted as reflecting cognitive biases or errors in human decision making but can be explained more persuasively by other explanations.

The "endowment effect"—overestimating the value of one's possessions—was once considered to be one of the best known and most robust theories in behavioral economics, serving as the basis for hundreds of articles in economics, law, and other fields.[53] Analysis by Charles Plott and Kathy Zeiler, however, has cast doubt on the existence and robustness of a stable endowment effect, attributing positive findings to elements of experimental design, not a robust, context-independent finding of a stable preference.[54] As a result, the positive finding of an endowment effect is believed to be highly contingent on the design of the experiment, and variations in experimental design can produce multiple outcomes.[55]

Leaving aside questions about the robustness of findings of an endowment effect in economic experiments, economist Jonathan List has raised questions about the degree to which the endowment effect can be generalized as being relevant to behavior outside the artificial-choice

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[52] *See* Colin Camerer, et al., *Evaluating Replicability of Laboratory Experiments in Economics*, 351 Science 1433 (Issue 6280, Mar. 25, 2016). The authors note that the finding that a "significant effect in the same direction as in the original study" could be replicated in only 61% of the cases was "considerably lower than the replication rate of 92% (mean power) that would be expected if all original effects were true and accurately estimated." It is not evident from the report how many of those experiments specifically tested BE-related hypotheses and whether those findings were more robust than other types of experiments.

[53] *See* Jack Knetsch, Fang-Fang Tang, and Richard Thaler, *The Endowment Effect and Repeated Market Trials: Is the Vickrey Auction Demand Revealing?*, 4 Experimental Economics 257 (2001) (calling the endowment effect "one of the most robust findings in the psychology of decision making").

[54] See Chareles R. Plott and Kathy Zeiler, Exchange Asymmetries Incorrectly Interpreted as Evidence of Endowment Effect Theory and Prospect Theory?,

97 Am. Econ. Rev. 1449 (2007); Charles R. Plott and Kathy Zeiler, The Willingness to Pay-Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations, 95 Am. Econ. Rev. 530 (2005); see also Charles R. Plott and Kathey Zeiler, The Willingness to Pay-Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations: Reply, 101 Am. Econ. Rev. 1012 (2011).

[55] *See* Durkin, et al., *supra* note 1, at 146-48.

environment of the economics laboratory.[56] In particular, List found that the behaviors that had been identified as evidence of an endowment effect became weaker as people developed experience making choices in real markets and had incentives to improve their decision making. Subsequent research by Engelmann and Hollard concluded that behavior that was attributed to the endowment effect might have actually reflected some uncertainty about the trading procedure itself, perhaps as a result of perceived transaction costs or risks.[57] Manne and Zywicki have noted that even if the endowment effect exists, this would not meaningfully affect market efficiency, because it would create a profit opportunity for entry by those who are not subject to those biases, such as corporations.[58] Overall, analysis has raised doubts about the existence and strength of the endowment effect in general; and, even if behavior consistent with the theory is observed, the applicability of the endowment effect is questionable in contexts where individuals have incentives to act rationally and opportunities to learn from experience.

The endowment effect is grounded in another foundational premise of BE and BLE, the related idea of "loss aversion," (i.e., that losses are systematically experienced as being more psychologically impactful than gains).[59] The idea of "loss aversion" has been proffered as the basis for a variety of observed behaviors and biases asserted to be inconsistent with neoclassical economics, including the endowment effect, "inequality aversion," and the "status quo bias."[60]

A review by Gal and Rucker of experimental studies supposedly finding evidence of loss aversion concluded that the claim of a stable "loss aversion" bias was: (1) often a manifestation of the experimental design used to test the concept, and (2) a misattribution of the motivations behind observed behavior to loss aversion instead of some other explanation.[61] According to Gal and

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[56] See Jonathan A. List, Does Market Experience Eliminate Market Anomalies? The Case of Exogenous Market Experience, 101 Am. Econ. Rev. 313 (2011); Jonathan A. List, Neoclassical Theory Versus Prospect Theory: Evidence from the Marketplace, 72 Econometrica 615 (2004); Jonathan A. List, Does Market Experience Eliminate Market Anomalies?, 118 Q. J. Econ. 41 (2003).

[57] Dirk Englemann and Guillaume Hollard, Reconsidering the Effect of Market Experience on the "Endowment Effect," 78 Econometrica (2010).

[58] *See* Geoffrey A. Manne and Todd J. Zywicki, *Uncertainty, Evolution, and Behavioral Economic Theory*, 10 J. L. Econ. & Policy 555 (2014).

[59] *See* Daniel Kahneman and Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979). Loss aversion is also referred to as "prospect theory."

[60] *See* Colin F. Camerer, *Three Cheers—Psychological, Theoretical, Empirical—For Loss Aversion*, 42 J. Marketing Research 129 (2005) (reviewing various theories linked to the premise of "loss aversion").

[61] David Gal and Dereck Rucker, The Loss of Loss Aversion: Will It Loom Larger Than Its Gain?, 28 J. of Consumer Psychology 497 (2018); see also David Gal and Dereck Rucker, Loss Aversion, Intellectual Inertia, and a Call for a More Contrarian Science: A Reply to Simonson & Kivetz and Higgins & LIberman, 28 J. Consumer Psychology 533 (2018).

Rucker, most of the experiments that claim to find evidence for loss aversion are fundamentally flawed in that they offer individuals just two choices—either to trade their existing endowment or to keep it.[62] When offered only these two choices, some 90 percent of participants choose to keep their initial endowment, regardless of what it is. But this result ignores a third possibility—that many participants in the experiment are largely indifferent between either of the two choices provided to them. Changes from the status quo require psychological and intellectual effort to undertake. Where individuals are indifferent between possessing two low-value and arbitrarily assigned entitlements, even a small amount of transaction costs or friction would be expected to be sufficient to obstruct trading. Indeed, when offered the third option of "indifferent between options," and not just the binary choice of whether to trade or not, a majority of participants select it. This suggests their decision not to trade has little to do with the presence of a supposed biases such as the endowment effect or loss aversion, but instead to the participants' absence of a preference for one of the items over the other, such that even a modest investment of time and energy to think about trading one item for another of comparable market and subjective value, is larger than any gains that might be achieved. Gal and Rucker conclude the concept of loss aversion is not stable to different choice contexts: "Our main conclusion is that the weight of the evidence does not support a general tendency for losses to be more psychologically impactful than gains (i.e., loss aversion). Rather, our review suggests the need for a more contextualized perspective whereby losses sometimes loom larger than gains, sometimes losses and gains have similar psychological impact, and sometimes gains loom larger than losses."[63]

As reported by Eldad Yechiam in a comprehensive review of studies on loss aversion, there is no consistent finding that individuals express a systematic asymmetry in their psychological experience of losses and gains.[64] Many of the studies that have purported to find evidence of loss aversion have failed efforts at replication. Moreover, "researchers have found a host of other asymmetries between gains and losses that occur simultaneously with no loss aversion. ... All these asymmetries were found to emerge in task conditions where individuals did not overweight losses compared to gains, which further suggests that the effect of losses on the human mind cannot be singly captured by loss aversion."[65] Yechiam concluded that where

[62] In most experiments of the endowment effect and loss aversion, individuals are divided into to two groups and randomly endowed with two arbitrary alternatives of small and more or less equivalent market value, such as a pen or coffee mug and then are invited to trade.

[63] *See* Gal and Rucker, *Loss of Loss Aversion*, *supra* note 61, at 498.

[64] See Eldad Yechiam, Acceptable Losses: the Debatable Origins of Loss Aversion, 83 Psychological Research 1327 (2019).

[65] *Id.* at 1329.

behavior is found that is consistent with the theory of loss aversion, it actually reflects an aversion to "high-stakes losses" and "gain/loss neutrality for small-to-moderate losses," not a uniform tendency toward loss aversion.[66] Moreover, Yechiam notes the findings of some of these studies have been systematically misrepresented to reflect loss aversion, though they did not actually find it. In many instances, where behavior consistent with loss aversion is observed, that behavior could be explained by alternative theories that are at least as intuitively persuasive as loss aversion. As Yechiam concluded[67]:

> The current review suggests that the literature concerning losses existing in and prior to Kahneman and Tversky has been overinterpreted by Kahneman and Tversky and in the subsequent literature. First of all, the preponderance of loss aversion ... seems to have been exaggerated, as this behavioral regularity was not observed in several studies, including studies that were cited as supporting loss aversion. Second, loss aversion in estimated utility functions was only observed in studies focusing on very high amounts and not in studies of small amounts. Third, even in the studies focusing on high amounts ... loss aversion was not observed for about half of the participants for the smallest amounts used, but only for higher amounts. These findings are difficult to reconcile using a "tilted scales" metaphor of losses being overweighted compared to gains; nevertheless, they were overinterpreted to indicate a general asymmetry in the utility function for gains and losses.[68]

Psychologist Gerd Gigerenzer has extensively documented problems with many of the supposed biases and anomalies that BE theorists have attributed to individual decision making. As Gigerenzer observes, from its initial promising roots in Simon's admonitions to take the ideas of bounded rationality more seriously in economic thought, BE has evolved under the influence of the heuristics-and-biases literature into a research program to identify deviations from the neoclassical economics paradigm, "or what it took that paradigm to be. Experimenters aimed at demonstrating 'anomalies' and 'biases' in human behavior."[69] As such, BE research has built its findings on a hodgepodge of findings drawn from unrepresentative choice contexts, generalized context-dependent findings to broader focus, failed to consider alternative hypotheses for observed behavior, and in some instances simply misunderstood the phenomena they were

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[66] Id.

[67] *Id.* at 1336 (citations omitted).

[68] Plott and Zeiler similarly noted that despite claims that the presence of the endowment effect was robust and important, a substantial minority of experiments had failed to find a gap between participants' willingness to pay and willingness to accept. *See* Plott and Zeiler, *supra* note 54 (noting that 12 of 39 experiments of the endowment effect failed to confirm the hypothesis even under their chosen experimental design).

[69] *See* Gerd Gigerenzer, *The Bias Bias in Behavioral Economics*, 5 Rev. of Behavioral Econ. 303, 304 (2018).

purporting to examine. Gigerenzer concludes that this redefinition of BE, away from its origins in understanding how people generally think and approach economic decisions toward an agenda-oriented approach of identifying and cataloging supposed biases, has led BE to its own problem—the "bias bias," or "the tendency to see systematic biases in behavior even when there is only unsystematic error or no verifiable error at all."[70]

Gigerenzer describes numerous supposed biases identified by BE researchers that, in fact, are not biases at all, such as the "hot hand" and "gambler's fallacies." BE researchers often also frequently assume that "logically equivalent frames" are "informationally equivalent," when in fact people construe information through a lens of shared communication and poorly worded questions that leads to erroneous interpretations of results.[71] Unsystematic errors are often believed by researchers to be systematic errors. Numerous other similar methodological and logical problems have been identified as plaguing the findings of BE.[72]

According to Gigerenzer, what is often believed by BE theorists to be evidence of biases or irrationalities can be more accurately understood as explaining how individuals actually make decisions under uncertainty, as opposed to the implicit assumption of decisions made under risk where all states of the world are potentially known in a probabilistic fashion.[73] In a context of uncertainty, as opposed to risk, so-called "fast-and-frugal heuristics" often lead to superior decision making compared with efforts to create more elaborate optimizing decision rules.[74] In fact, efforts to apply more elaborate decision-making rules can lead to worse outcomes. Decision making in the context of uncertainty has also been shown to explain what is often claimed to be evidence of hyperbolic discounting (i.e., the systematic preference for an immediate reward over a larger future award).[75]

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[70] *Id.* at 307.

[71] For example, Gigerenzer notes that in the famous "Linda Problem," which asks whether it is more likely that a hypothetical woman named "Linda" is just a "bank teller" or a "bank teller active in the feminist movement," the inclusion of the additional seemingly-extraneous information about Linda might logically be interpreted by participants in the study as asking for a different judgment than that intended by the experimenter. *See* Ralph Hertwig and Gerd Gigerenzer, *The "Conjuction Fallacy" Revisited: How Intelligent Inferences Look Like Reasoning Errors*, J. of Behavioral Decision Making (1999).

[72] For an extensive discussion, *see* Durkin, et al., *supra* note 1, at chapter 4.

[73] *Id.* at 329.

[74] *See* Gerd Gigerenzer and R. Selten, Bounded Rationality: The Adaptive Toolbox (2001); *see also* Gerd Gigerenzer, *How To Explain Behavior?*, Topics in Cognitive Science 1 (2019); Gerd Gigerenzer and Henry Brighton, *Homo Heuristics: Why Biased Minds Make Better Inferences*, 1 Topics in Cognitive Science 107 (2009).

[75] See Peter D. Sozou, On Hyperbolic Discounting and Uncertain Hazard Rates, 265 Proceedings of the Royal Society Lond. B. 2015 (1998); J. Doyne Farmer and John Geanakoplos, Hyperbolic Discounting Is Rational: Valuing the Far Future with Uncertain Discount Rates, Cowles Foundation Paper No. 1719 (Yale 2009).

Based on the state of knowledge about BE and the "biases-and-heuristics" research program, minimal confidence can be given to a viable alternative framework to analyze consumer financial economics and consumer financial protection policies, compared with the traditional model developed at the beginning of this chapter. Claims about the existence, strength, and frequency of various biases in the population are highly suspect. Many of the biases that are claimed to exist are potentially explained by alternative hypotheses about individual reasoning and behavior. Where potential biases are found to exist, they are usually context dependent, and it is difficult to identify *ex ante* which context can be expected to bring forth which biases and in what direction. For example, as noted, there are severe doubts about whether the "loss aversion" bias exists at all. But even if it does, it is context dependent, as different contexts produce behavior at different times that is consistent with loss aversion, gain preferring, or gain-loss neutrality. It is difficult to see how this somewhat *ad hoc* collection of purported biases and anomalies can provide a reliable foundation for a coherent system of consumer financial protection.

2. Weaknesses in BE's Theoretical Foundations as Applied in Particular Choice Contexts

Even if BE's foundational concepts are assumed to be empirically sound and generalizable beyond their specific laboratory contexts, there are profound challenges to applying those laboratory-induced findings to understand consumer demand for financial products in real-world choice contexts. As a matter of theory, at least three unresolved difficulties can be identified to general usage of BE as a theoretical framework for deriving a general theory of consumer demand for financial products and services: (1) selecting *which* of multiple potential biases supposedly applies in a given choice context and how to determine which bias will predominate if multiple different biases might apply, (2) *how* any specific biases will apply in a given choice context and what to do if different biases contradict one another, and (3) the problem of assessing the welfare effects of policies for consumers, especially given the abandonment of revealed preferences as the yardstick for measuring consumer welfare and moving toward untestable or even tautological hypotheses. Consider each of these three concerns in turn.

A. WHICH BIASES APPLY IN A PARTICULAR CONTEXT?

First, BE has no discernible or scientific theory of how to predict in any given choice context which of the nearly 200 different potential biases might apply and the magnitude of their effects. Indeed, BE's methodology on this point appears to be the opposite of standard economic methodology: Instead of specifying a model and its testable hypotheses, BE begins with an isolated observation of some consumer behavior that is asserted to be welfare reducing and inconsistent with the individual's true preferences, then retroactively attaches an *ad hoc* BE-based label to explain the purported choice of suboptimal behavior.[76] In many instances, however, the observed behavior can be understood as a rational response to the individual's constraints and choice context.[77] For example, in predicting whether someone is going to take an action such as starting a new business or buying a home, how does the observer know whether the individual is likely to be motivated by the "status quo bias" on one hand—which would suggest undue passivity, pessimism, "loss aversion," and inertia about starting the new business—or the "optimism" or "wishful thinking" bias on the other—which would predict to make him or her unduly optimistic about the new business or the future expected path of home prices? Or what if different purported biases apply to different people in different ways at different times in different choice contexts? How is a policymaker supposed to predict as a matter of theory whether those biases will cancel out, exacerbate each other, or some combination for different people at different times?

The problem becomes even more difficult when the policymaker must weigh two or more competing policy options through the lens of BE. Consider the issue of mortgage choice and its relationship to the 2008 mortgage-induced financial crisis. Leaving aside obvious problems of fraud in the marketing and origin of some mortgages during that period, many consumers simply made mistakes about the wisdom of home-buying and mortgage choices largely because of mistaken assumptions about the future expected path of home prices and interest rates. In particular, some consumers took out higher-cost subprime mortgages with adjustable interest rates based on unduly optimistic projections about the future path of housing prices, leading them to take on greater leverage and pay a higher price to purchase a home than was warranted in light of subsequent developments.[78] Some commentators have attributed the boom in housing prices and use of subprime mortgages to a grab bag of widespread behavioral biases that supposedly led to those mistakes.[79]

[76] *See* Zywicki, *Just-So Stories*, *supra* note 34, at 187-89.

[77] Id.

[78] Although such behavior may be rational in asset markets where valuations are determined by parties' expectations of future price behavior, not underlying use values, giving rise to "asset bubbles." *See* Steven D. Gjerstad and Vernon L. Smith, Rethinking Housing Bubbles: The Role of Household and Bank Balance Sheets in Modeling Economic Cycles (2014).

[79] See Oren Bar-Gill, The Law, Economics, and Psychology of Subprime Mortgage Contracts, 94 Cornell L. Rev. 1073 (2009).

Regardless whether they held prime or subprime mortgages, homeowners who took out adjustable-rate mortgages when the Federal Reserve initially drove down short-term interest rates in the early 2000s obviously suffered when the Fed reversed course a few years later and dramatically raised rates.[80] But many consumers also make mistakes and suffer welfare losses, judged after the fact, when they decide to take out a traditional 30-year, fixed-rate mortgage with an unlimited right to prepay.[81] Homeowners pay a substantial interest-rate premium for a fixed-rate mortgage that can amount to thousands or tens of thousands of dollars over the life of the mortgage to purchase long-term insurance against future increases in interest rates.[82] Consumers who purchase a home using a fixed-rate mortgage suffer losses if interest rates fall and they are locked into a higher rate (or have to spend a substantial sum in closing costs to refinance) or sell their house and move earlier than expected (thus losing the benefit of the premium they paid for long-term interest-rate stability). If their house has declined in value in the meantime and they are in a negative equity position, they will be able to refinance into a lower rate only if they can also come up with sufficient amounts of cash to cover the shortfall on the prior mortgage.[83]

It is not difficult to identify homeowners who suffered wealth losses because they chose an adjustable-rate mortgage instead of a fixed-rate mortgage and then attribute those decisions *post hoc* to the presence of some bias. But it also is not difficult to identify homeowners who suffered losses because they chose the opposite and attribute those *post hoc* to the same or other biases.[84] It is also not difficult to provide after-the-fact explanations grounded in the *ad hoc* application of various cognitive biases to explain the choices that led to these mistakes, regardless of whether adjustable-rate or fixed-rate mortgages. If some homeowners select an adjustable-rate mortgage and interest rates increase then they could be said to have made errors of optimism, hyperbolic discounting, or some other bias that produced their error. If others

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[80] *See See* Todd J. Zywicki and Gabriel Okloski, *The Housing Market Crash*, Mercatus Center Working Paper No. 09-35 (Sept. 2009).

[81] *See* Zywicki, *Just-So Stories*, *supra* note 34.

[82] The average premium for a fixed-rate mortgage over an adjustable-rate mortgage is about 100 basis points. *See id.*

[83] See id.

[84] *See id.* In fact, available evidence indicates that consumers generally choose between adjustable and fixed rate mortgages in a fashion consistent with the predictions of economic rationality, namely, those with shorter time horizons who plan to move within a few years tend to be more likely to choose adjustable-rate mortgages than those who are expecting to stay put for a longer time. with respect to the particular question of mortgage choice during the housing boom, the increasing market share between fixed and adjustable rate mortgages was explained by changes in the relative price differentials between the two products created by the Federal Reserve's interest rate policies during that period. *See* Todd J. Zywicki and Gabriel Okloski, *The Housing Market Crash*, Mercatus Center Working Paper No. 09-35 (Sept. 2009).

select fixed-rate mortgages and interest rates fall, then this outcome could be attributed to biases such as status-quo bias or loss aversion. In short, any ex post outcome that turns out to be suboptimal for some consumers could be chalked up to behavioral biases. A theory malleable enough to explain both the overuse of adjustable-rate mortgages and the opposite is of limited usefulness as a foundation for understanding consumer demand.[85]

B. HOW DO BIASES MANIFEST THEMSELVES IN PARTICULAR CONTEXTS?

A second theoretical problem for efforts to develop a robust and useful BE model of consumer finance and consumer financial protection is the difficulty of determining whether and which biases will apply in a particular choice context. Thus, the same bias might generate completely contradictory predictions depending on how the choice context is identified.

Consider the most prominent example of BE policy analysis—the argument that individuals save too little (i.e., undersave) for retirement relative to their supposed true preference to save more.[86] This failure to save as much as people say they want to do is supposed to be attributable to a variety of cognitive biases that are said to favor short-term consumption over long-term savings for retirement, including self-control problems, procrastination, and hyperbolic discounting.[87] Under the logic of this argument, the failure to save adequately can be assessed by the difference between the amount that people say they want to save and the amount they actually do save each month. This supposed difference between what people do and what they say they want to do leads to the policy idea that workers should be nudged or required to increase their retirement savings by being automatically enrolled in their company's employer-provided retirement plan, which would increase the number of people participating in the plan.

But comparison of what individuals do in real-world contexts with what they say they might prefer under unconstrained conditions is less than a meaningful test. Probably almost everyone would prefer to save more for retirement if it does not interfere with other goals. As will be discussed further in Chapter 12, evidence reveals that the vast majority of current and future retirees currently are saving enough or more than enough for retirement, especially once government benefits are taken into account.[88] Fewer retirees today are struggling financially than the general population and only a minority of current workers are potentially on course to retire with inadequate resources.

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[85] *See* Zywicki, *Just-So Stories*, *supra* note 34.

[86] *See* Richard H. Thaler and Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness 106-07 (2008).

[87] *See* discussion in Zywicki, *supra* note **Error! Bookmark not defined.**.

[88] *See* Zywicki, *Save Too Little*, *supra* note **Error! Bookmark not defined.**..

But even those now saving less than average might be doing so only temporarily in light of the dynamics of their financial life cycles, changes in the dynamics of work and retirement, and the availability of government social welfare benefits. Changes in savings behavior over time should be taken into account rather than just compared with surveys of some preferred but unconstrained behavior like preferring additional retirement saving now. For instance, saving by higher income Americans should be reevaluated to account for their changing work and retirement habits, especially the tendencies of higher-income individuals to work longer and beyond the traditional retirement age and to increase their pace of retirement savings after satisfying more urgent spending and savings priorities in their family-building years, such as saving for a home purchase and college for children. With respect to lower-income families, the progressive nature of the social security system means that lower-income families will receive a higher replacement percentage of their income in retirement than average, reducing their need for private savings. Also, unfortunately, lower-income workers tend to have shorter lifespans on average than higher-income workers, but this reduces their need for large private retirement savings. But is it possible to state without equivocation that BE theory predicts that people systematically will undersave for retirement, and could one confidently assume that pushing them or requiring them to save more today would make them better off?

But BE identifies other biases that might be equally relevant to savings decisions and would predict that people will oversave for retirement.[89] For example, one supposed manifestation of the "optimism" bias is that people hold unrealistically optimistic opinions about their chances to live a long life and underestimate their likelihood of premature death as a result of accident or disease.[90] For example, the average 30-year-old American faces a 15 percent to 20 percent likelihood of dying before he or she reaches age 70.[91] If the optimism bias is accurate, this suggests that some people are oversaving for retirement, regardless of responses to surveys about implicitly unconstrained situations, because they are overoptimistic about their expected probability of living to retirement age and therefore are unrealistically deferring income to enjoy in retirement, which some of them are unlikely to ever see.[92] Yet they bear the cost of this overoptimistic biased estimate of life expectancy if they have to forego current enjoyment today,

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[89] Zywicki, *supra* note **Error! Bookmark not defined.**; Zywicki, *Just-So Stories supra* note 34.

[90] Individuals also supposedly underestimate their probability of getting divorced in the future, which if known accurately would be likely to produce

reduced savings and increased consumption during married life. *See* Zywicki, *Just-So*, *supra* note 34.

[91] *See* Any Kiersz, *This Is When You're Going to Die*, Business Insider (Mar. 21, 2014), http://www.businessinsider.com/social-security-life-table-charts-2014-3.

[92] Zywicki, *supra* note **Error! Bookmark not defined.**.

either by working more or foregoing consumption, to shift income to a speculative future they will never achieve.

And the propensity to save is not randomly distributed in the population, just as life expectancy is not randomly distributed.[93] Savings and other financial habits are correlated with other behaviors that affect mortality, such as eating, sleeping, working, exercising, weight, and smoking habits.[94] Savings and other financial habits are correlated with other behaviors that impact mortality, such as eating, sleeping, working, exercise, weight, and smoking habits. In general, those who save less than average for retirement are also those who tend to live a lifestyle that is correlated with an increased risk of premature death, such as smoking, working in a dangerous occupation, or being overweight. By contrast, those with higher levels of income and education tend to both save and live longer than average. Thus, it is appears that those who are saving more, less, or the average amounts may not be exhibiting biases but actually may be saving optimally given their expected life expectancies.[95] As a result, policies designed to induce a savings rate based on a measure of average life expectancy and average retirement financial needs could have the unintended consequence of displacing this more nuanced pattern of the relationship between savings behavior and life expectancy with a crude default rule that reduces the fit for either group.[96]

Moreover, a natural limitation of human experience is that people have difficulty accurately projecting what their lives will be like in retirement. Many people believe they will be healthier and more active when they retire than they actually will be, thus they may overestimate their expected spending on travel and other activities. They may also underestimate how much their living costs will decline in retirement by eliminating from their budget the costs associated with working full time (taxes, commuting, clothing, etc.), as well as replacement rates of consumer durable goods, such as automobiles, furniture, and appliances. Because they have more time available, most retirees also substitute home production for many services they purchased when they were working, such as food preparation, home cleaning, lawn care, and home repair

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93 Zywicki, *supra* note **Error! Bookmark not defined.**.

94 Zywicki, *supra* note **Error! Bookmark not defined.**, at 912-13.

95 *See* Zywicki, *supra* note **Error! Bookmark not defined.**.

96 In addition, automatically enrolling workers in a retirement plan with a default contribution rate can increase contributions in the short-term from those contributing less than average but can also reduce the contribution rate of those who were previously saving more than average. *See* Brigitte C. Madrian and Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q. J. Econ. 1149 (2001); *see also* Mario J. Rizzo and Glen Whitman, Escaping Paternalism: Rationality, Behavioral Economics, and Public Policy 303-06 (2020) (discussing studies).

services. As a result of these unanticipated reductions in spending, many retirees today actually build wealth in retirement instead of drawing it down.[97]

Overall, it simply is not possible for any economist to be confident that people will be made better off by shifting income from today to decades into the future without knowing their current and future budget constraints and uncertainties about their projected life expectancies. Because of inherent household budget constraints, increasing one's retirement savings now can only be funded by reallocating funds from their current allocation to fund future consumption.[98] There are costs to deferring income, and they include not only reducing current consumption, but also potentially giving up valuable household investment opportunities. Other sacrifices could include challenges in meeting the expenses associated with raising children, reducing saving for other purposes (such as an emergency reserve fund, a home purchase, or college savings), needing to work more to increase income at the expense of time for family and personal development (such as exercise or enjoyable hobbies); or to simultaneously save more for retirement while increasing usage of high-cost consumer credit to maintain one's preferred level of consumption. As noted above, surveys of those who are not saving for retirement indicate that only a trivial number fail to do so because of BE-style motivations, such as "not having taken the time to do it," as opposed to weightier concerns such as not being eligible, trying to make ends meet month to month, paying down consumer debt or student loans, or saving for some other priority such as a home or college education. Moreover, as noted, between one-fifth and one-sixth of working-age adults will not survive to retirement age to enjoy their deferred resources. Thus, although changing the default rule with respect to enrollment in retirement plans could increase the overall rate of retiring saving, which by itself is unclear, this effect cannot be assumed to increase overall welfare without also understanding the opportunity cost associated with budget-constrained households reallocating those resources from some other, usually also high-valued, purpose.[99]

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[97] *See* David A. Love, Michael G. Palumbo & Paul A. Smith, *The Trajectory of Wealth in Retirement*, 93 J. Pub. Econ. 1-2, 191 (2009), *available at* http://www.sciencedirect.com/science/article/pii/S0047272708001311.

[98] *See* discussion in chapter 12; Zywicki, *supra* note **Error! Bookmark not defined.**.

[99] An additional example is the idea of "cooling-off" periods, which give consumers an opportunity to make a purchase but then to rescind it within a specified time period. Some behavioral economists have argued that cooling off periods are useful for consumers to overcome certain biases, such as hyperbolic discounting or myopia. On the other hand, cooling-off periods could be argued to be ineffective because of biases such as the status quo bias or commitment bias. *See* Beales, *To BE*, *supra* note **Error! Bookmark not defined.**, at 361. Indeed, such remedies could even be argued to be counterproductive, if consumers are more likely to make a purchase than otherwise based on a belief that they can return it if they change their mind but have an unrealistic assessment of their likelihood of doing so. [Sentence is confusing. Needed?]

A second example of the theoretical limits of BLE and predicting how purported biases will manifest themselves in particular choice contexts relates to the question of whether merchants should be permitted to impose a surcharge fee on customers who want to pay using a payment card (debit, credit, or prepaid card) instead of simply being permitted to offer a discount for using other types of payment.[100] Federal law requires that merchants be permitted to offer a cash discount to consumers as part of their agreement with credit card issuers, although many states have banned surcharging of card transactions.[101] Merchants, however, have wanted to be allowed to impose a surcharge to recover the credit card merchant discount fees incurred when a consumer pays using a card.

A group of American self-styled behavioral economists supported the merchants demand to be allowed to surcharge payment-card transactions and not just to offer a discount, asserting that having the ability to impose surcharges would be more effective at redirecting consumers to use a noncard alternative. They argued that even though a surcharge and discount were mathematically equivalent, labeling the price differential a "surcharge" instead of a "discount" would psychologically frame the issue as a "loss" to the consumer. This framing supposedly would trigger certain behavioral biases such as loss aversion and the endowment effect that would persuade consumers to more readily try to avoid the penalty by switching to a different payment mechanism.[102] Permitting a cash discount, by contrast, was asserted to be less effective because it would frame the transaction as a "gain," which supposedly would cause consumers to be less responsive to the fee. As a result, permitting surcharging was asserted to be more effective at deterring use of payment cards than discounting and thereby would increase overall consumer welfare by reducing merchant costs. The proponents of the argument offered no real-world empirical support for their hypothesis (and the limited evidence that is available suggests the opposite).[103]

The *a priori* reasoning of the American BLE scholars was striking because another group of BLE analysts, this one in the United Kingdom's Office of Fair Trading (OFT), examined the same pricing practice of surcharging and reached the opposite conclusion with respect to the welfare consequences for consumers. According to the OFT, this marketing scheme of announcing a

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[100] See Todd J. Zywicki, Geoffrey A. Manne, and Kristian Stout, Behavioral Economics Goes to Court: The Fundamental Flaws in the Behavioral Law & Economics Arguments Against No-Surcharge Laws, 82 Missouri L. Rev. 769 (2017).

[101] Agreements between payment card networks and merchants also historically banned surcharging but those provisions were removed pursuant to a litigation settlement.

[102] *See* discussion *id.*

[103] Id.

lower up-front price and then adding fees later in the transaction process—a practice known as "drip pricing"—is one of the most harmful pricing practices for consumer welfare, as consumers rarely change their mind about going through with the transaction once they have reached that point but instead simply go through with it and pay the higher price.[104] Of particular note, the OFT pointed to several of the same biases to criticize surcharging that the American BLE scholars pointed to in supporting surcharging, such as the endowment effect. In other words, applying BE concepts to the same transactional context—allowing merchants to impose surcharges on consumers for using payment cards to conduct a transaction—American and British experts in behavioral economics reached the opposite conclusions about the welfare consequences of that policy for consumers. Once again, BE theories can be invoked in support of permitting something and its opposite.

Additionally, the example of surcharging, like BLE proposals to increase savings by manipulating default rules, illustrates the potential for BLE-based policies to backfire and result in harm to consumers. As explained by Zywicki, Manne, and Stout, there is an alternative explanation for why merchants want to surcharge payment card transactions, instead of just offering cash discounts: Surcharging (but not discounting) enables merchants to extract wealth by imposing surcharges where consumers have a highly inelastic demand for using cards and so are unable to reasonably avoid the fee by switching to an alternative payment device. This includes such transactions purchasing airline tickets, other travel, hotel rooms, items over the internet, and sit-down restaurants, or where consumers are not repeat customers and thus can be fooled by the merchant's drip-pricing techniques of luring consumers with a lower posted price and imposing a higher price that includes the surcharge later.[105] In fact, reviewing the evidence from countries where surcharging has been permitted indicates that merchants do not impose surcharges uniformly across industries but are much more likely to impose surcharges on payment cards in markets where consumers have less ability to substitute to alternative types of payments, such as those mentioned. Moreover, where surcharging has been permitted, merchants universally surcharge well above any reasonable estimate of their actual costs of accepting cards, which strongly suggests that merchants use surcharges as a profit center to extract wealth from consumers, instead of merely to cover their costs or to try to redirect consumers to an alternative payment device. In fact, far from using surcharges as a vehicle to persuade consumers to substitute some other payment device, such as cash, surcharging is most

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[104] *Id.* at 834-40.

[105] *See* Zywicki, Manne, and Stout, *supra* note 100; *see also* Helene Bourguignon, Renato Gomes, and Jean Tirole, *Credit Surcharges and Cash Discounts: Simple Economics and Regulatory Lessons*, 10 Competition Pol'y Int'l 12, 20 (2014).

prominent in transaction settings where consumers are least likely to be able to substitute to a noncard alternative.[106]

C. ABANDONING REVEALED PREFERENCE IN FAVOR OF TAUTOLOGICAL OR UNTESTABLE HYPOTHESES

An additional problem with using BE as a foundation for consumer financial protection policy involves properly specifying testable hypotheses concerning the ability of BE to explain observed behavior and the welfare consequences of some of its policy recommendations. In some instances, this can collapse into tautological reasoning. If BE theorists propose a policy intervention (such as a "nudge") that is supposed to correct a problematic consumer behavior but the behavior is not observed to change, the BLE theorist concludes that the bias or anomaly is just more rigid than originally thought.

This problem of untestable and potentially tautological hypotheses stems from abandoning a consumer's revealed preferences as the benchmark for assessing consumer welfare. Once revealed preference is abandoned, the theorist drives a wedge between an individual's preferences as shown by actual choices made subject to existing constraints and what the theorist posits to be the individual's true preferences. As noted, preferences are inherently subjective and context dependent, such that an individual's preferred choices might differ over time or depending on the constraints and opportunities presented at the moment of making a choice. As a result, the theorist faces the daunting task of trying to reconstruct what constitutes the individual's true preferences in a choice context without referring to the consumer's actual choices as their presumptively preferred choice.

Consider as an example, consumer usage of bank overdraft protection. Many commentators have expressed concerns that some consumers use overdraft protection "excessively," leading them to pay what behavioral economists believe to be excessive fees from frequent use of the product. Exemplifying these concerns, in 2010 federal financial regulators enacted a rule that banks can assess a fee for clearing a payment using overdraft protection for an ATM or nonrecurring debit card transaction only if the consumer affirmatively "opts in" to authorize the use of the service in that context, as opposed to the prior regime that authorized the bank to automatically enroll customers in overdraft protection for those transactions subject to the consumer "opting out."

The policy was applauded initially by BLE scholars, who saw changing the default rule from opt out to opt in as a useful nudge to induce consumers, especially more frequent users, to reduce

[106] Id.

their use of overdraft protection by raising the costs of using overdraft.[107] According to some BLE theorists, overdraft protection for ATM and debit card transactions is used to "exploit consumer mistakes" and "provide[s] little social value."[108] The primary intended beneficiaries of the new rule were those who used overdraft protection frequently, as it was assumed they would benefit the most from making it more difficult to access overdraft protection.

After the adoption of the rule, however, frequent overdraft users were substantially more likely to opt into the usage of overdraft protection than those who rarely or never used it. Moreover, the likelihood of opting in increased in a linear fashion from those who never used the service (and who rarely opted in) to those who used the service frequently (and who opted in at the highest rates). BLE theorists view this tendency of more frequent users to opt in after the rule change as confirming their prior assumptions about the irrationality of frequent overdraft users and their susceptibility to manipulation by financial institutions through aggressive sales techniques. They did not consider any alternative hypothesis that might be consistent with consumer rationality.

For BLE theorists, the finding that frequent users of overdraft protection were also those who were most likely to opt in after the rule change is itself evidence of the depth of irrationality and lack of self-control among some consumers and the need for heightened efforts to protect them from themselves and banks.[109] But the conclusion that the failure to respond to the nudge demonstrates the irrationality of the underlying behavior is tautological—the nonresponsiveness of some consumers to a policy that is supposedly there to protect them from their own irrationality cannot be offered as proof of that premise that they are irrational. Under the reasoning of BLE theorists, no response by consumers could disprove the hypothesis that frequent usage of overdraft is driven by consumer irrationality and biased decision making: If usage by frequent users declined after the rule change, that would confirm the hypothesis that consumers had been fooled into using overdraft protection irrationally and changing the default rule was sufficient to overcome their biases, but if usage among frequent users did not change substantially (which was what actually happened), that would prove instead that they were even more biased and irrational than originally believed, and that more severe steps would need to be taken to protect them from themselves.

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[107] *See* Lauren Willis, *When Nudges Fail: Slippery Defaults*, 80 U. Chi. L. Rev. 1155 (2013); *see also* Ryan Bubb & Richard Pildes, *How Behavioral Economics Trims its Sails and Why*, 127 Harv. L. Rev. 61 (2014).

[108] Bubb & Pildes, *supra* note **Error! Bookmark not defined.**.

[109] *See* Todd Zywicki, *Behavioral Law and Economics and Bank Overdraft Protection*, The Volokh Conspiracy (Nov. 20, 2013), *available in* http://volokh.com/2013/11/20/behavioral-law-economics-bank-overdraft-protection/,

There is an alternative hypothesis that does not rest on tautological reasoning and a self-confirming hypothesis of consumer irrationality—those who were more likely to opt into overdraft protection after the rule change were those who find greater value in the product and were willing to go to the additional effort to opt in.[110] Standard economic theory holds that those who would be willing to do so would be those who have the strongest and most inelastic demand for the product. In fact, frequent users of bank overdraft protection say the reason they use the product because they have poor credit and limited choice due to lack of access to other, more desirable types of credit, such as credit cards.[111] For the average heavy user of overdraft protection, the next best alternative is usually a payday loan, which can be comparable in cost to the consumer but often less convenient to use. Given their limited choices among a set of unattractive and constrained options, those who had the strongest and most inelastic demand for overdraft protection would be predicted to be most likely to opt in.[112]

3. BE's Empirical Foundations as Applied to Consumer Finance

A third problem area for a BE-based consumer financial protection policy program is its poor success in finding empirical support for its hypotheses in real-world contexts outside the artificial laboratory environment. This failure of BE as an empirical research program is ironic in light of its central claim that it predicts observed behavior by consumers more accurately than does the rationality-based assumptions of the neoclassical model. Yet when BE's hypotheses are tested empirically, they typically fail when compared to the traditional model of consumer demand for financial services laid out in the first half of this chapter.

Usage of consumer credit provides a readily-available testing ground for the claims of BE theories versus neoclassical theories of consumer finance. As noted above, the predictions of BE and BLE theories differ from traditional theory in three dimensions. Both theories accept the reality that in a world of uncertainty combined with imperfect and costly information, consumers will make mistakes in their selection and usage of consumer credit products. But they differ in important ways.

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110 *Id*

111 *See* Robert L. Clarke and Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 Rev. of Banking and Fin. Law.235 (2013-14) (summarizing research); Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, 69 Wash. & Lee L. Rev. 1141 (2012).

112 *See also* Fumiko Hayashi and Emily Cuddy, *Recurrent Overdrafts: A Deliberate Decision by Some Prepaid Card Holders?*, Fed. Res. Bank of Kansas City Research Working Paper RWP 14-08 (Oct. 2015).

The neoclassical model predicts: (1) Most consumers will choose correctly in the sense of making choices that increase their welfare and avoiding those that make them worse off, (2) errors will be systematically unbiased, and (3) consumers generally will learn from their mistakes over time, will take actions to change their future course of action in response to past mistakes, and their propensity to take corrective action will be related to the costliness of their mistake. The BE model, by contrast, predicts: (1) Most or a large number of consumers will make mistakes with respect to their choices, frequently making choices that result in reducing their welfare, (2) errors will be systematically biased, resulting in large welfare losses, and (3) because of the deep-seated and unconscious nature of many of their biases, consumers will be slow to learn from their mistakes and slow to change their behavior going forward to reduce those losses.

There are few papers that directly attempt to test BE hypotheses of consumer finance against predictions provided by the neoclassical model. Although many examples could be provided, two notable examples are briefly discussed here: credit card usage and payday loan usage. In both instances, the predictions of BE have been roundly rejected.

One of the most prominent applications of BLE has been to the analysis of credit card usage by consumers.[113] Law professor Oren Bar-Gill has argued that consumer usage of credit cards is explained by a variety of behavioral biases that lead consumers to overuse credit cards and to make expensive mistakes that reduce their economic welfare. Bar-Gill identifies the "underestimation" bias as a primary source of irrationality, exacerbated by problems of hyperbolic discounting. Bar-Gill claims that biases such as hyperbolic discounting and lack of self-control create a baseline problem where consumers are unable to govern their spending impulses, which are empowered by the ability to make purchases with their credit cards even without sufficient liquidity. He claims that consumers then justify these purchases by telling themselves that they will pay for those purchases at the end of the month when the bill comes due, but because of the "underestimation" bias, consumers are unrealistically optimistic in their ability to pay their credit card statement in full when due. This leads them to unexpectedly revolve their balance to the next month, at which time the dynamic repeats itself . Indeed, according to Bar-Gill, "credit card financing [is] *uniquely* vulnerable to the underestimation bias" compared with other types of consumer credit such as closed-end installment loans.[114]

According to Bar-Gill, these same biases to focus on short-term rewards at the expense of long-term costs also affect the shopping process for credit cards. In particular, the unrealistic beliefs

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[113] *See* Bar-Gill, *supra* note **Error! Bookmark not defined.**.

[114] Bar-Gill, *supra* note **Error! Bookmark not defined.**, at 1379.

of consumers that they will not revolve their credit card balances leads them to undervalue the importance of interest rates when they choose their credit card and to focus unduly on short-term features such as the annual fee, rewards, and short-term "teaser" rates. As a result, once consumers end up revolving their balances, they pay higher APRs and larger finance charges than they would have if they had instead shopped for their card based on a more realistic assessment of their probability of revolving their balances. Bar-Gill also proposes some ancillary hypotheses, such as the prediction that debit cards would never gain substantial market share in the United States because of the inability of debit card issuers to exploit consumer's underestimation bias and the temptation of deferred payments.[115]

Summarizing his argument, Bar-Gill believes: (1) consumers frequently err in their usage of credit cards, specifically by underestimating their likelihood of revolving their balances from month to month, (2) consumer errors are systematically biased, in that consumers are much more likely to underestimate their likelihood of revolving their balances than to overestimate, and (3) consumers do not learn from their mistakes, and as a result continue to make the same mistakes repeatedly, leading to ever-growing mountains of debt and ever-higher finance charges until they finally collapse under the weight of their debt.

Bar-Gill did not attempt to provide much empirical support for his claims, but they were evaluated by Durkin, Elliehausen, and Zywicki.[116] Reviewing existing data and empirical studies, Durkin, et al., concluded that none of the hypotheses suggested by Bar-Gill's arguments were confirmed empirically: (1) The majority of consumers accurately predict their likelihood of revolving their balances from month to month, and in selecting their credit card, those who expect to revolve their balances are more aware of their APR and more likely to change credit cards in response to an offer of a lower APR than those who do not revolve their balances; (2) any errors that consumers make with respect to their credit card choice and usage is unbiased, meaning that consumers are no more likely to underestimate their potential to revolve balances than they are to overestimate it; and (3) consumers who make mistakes with respect to credit card selection respond by adjusting their behavior going forward, and the larger the size and cost of their mistakes, the more likely they are to alter their future behavior.[117]

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[115] *Id.* at 1378.

[116] Thomas A. Durkin, Gregory Elliehausen, and Todd J. Zywicki, An Assessment of Behavioral Law and Economics Contentions and What We Know Empirically about Credit Card Use by Consumers, 22 Supreme Ct. Econ. Rev. 1 (2015).

[117] *See* Sumit Agarwal, Souphala Chomsisengphet, Chunlin Liu, and Nicholas S. Souleles, *Do Consumers Choose the Right Credit Contracts*, 4 The Rev. of Corp. Fin. Studs. 239 (2015).

In addition, Durkin, et al., concluded that contrary to Bar-Gill's prediction, debit cards would gain only "limited success vis-à-vis the credit card," debit card usage surpassed credit card usage in transaction volume the next year.[118] Nor has there been evidence that credit card usage had created an upward spiral in household indebtedness over time leading to increased risk of financial breakdown. Consumers were also not found to be irrationally responsive to short-term product attributes such as credit card rewards or teaser rates.[119] In short, there appears to be little evidence to support the hypothesis that consumer credit card usage is better explained by BE or BLE theories of consumer demand than the traditional model.

Use of alternative financial products has also been the subject of BLE theorizing about consumer demand for financial products. Relying on many of the same purported biases as with credit cards, BLE theorists have argued that the initial decision to take out a payday loan and then to roll over the loan is motivated by behavioral biases such as optimism, imperfect self-control, status quo bias, and hyperbolic discounting.[120] Empirical studies by Ronald Mann[121] and Allcott, et al.,[122] test the hypothesis that payday-loan borrowers are systematically overoptimistic in their beliefs about their likelihood of rolling over their payday loans. Mann surveyed payday-loan customers about their expectations of how many periods it would take them to repay their loans and then compared their predictions with their actual performance. He found that a majority (60 percent) of customers correctly predicted at the time of their loan how long it would take to repay the loan, and that errors among those who did not accurately predict the time to repay were unbiased, meaning that payday-loan customers were just as likely to repay their loans earlier than expected as they were to repay their loans later than expected.

Using a similar methodology to Mann, Allcott, et al., found that "[O]n average, people almost fully anticipate their high likelihood of repeat borrowing." They also found that payday-loan borrowers learned with experience, and although inexperienced borrowers did understate their

118 The 2010 Federal Reserve Payments Study, Noncash Payment Trends in the United States: 2006-2009 at 5, Exhibit 2 (Apr. 5, 2011). In 2006, 27% of noncash transactions were made by debit card and 23% by credit card. In 2003, 19% of noncash payments were made by debit and 23% by credit card. *See* the 2007 Federal Reserve Payments Study, Noncash Payment Trends in the United States: 2003-2006 at 5, Exhibit 2 (Dec. 10, 2007).

119 See Howard Beales and Lacey L. Plache, Rationality, Revolving, and Rewards: An Analysis of Revolving Behavior on New Credit Cards, 21 S Ct Econ Rev 133 (2014); Tom Brown and Lacey Plache, Paying with Plastic: Maybe Not so Crazy. 73 U Chi L Rev 63 (2006).

120 See T.R. Harmon-Kizer, Let the Borrower Beware: Towards a Framework for Debiasing Rollover Behavior in the Payday Loan Industry, 42 J. Consumer Policy 245 (2019).

121 Ronald Mann, *Assessing the Optimism of Payday Loan Borrowers*, 21 S. Ct. Econ. Rev. 105 (2014)

122 Hunt Allcott, Joshua Kim, Dmitry Taubinsky, and Jonathan Zinman, *Are High-Interest Loans Predatory? Theory and Evidence from Payday Lending*, working paper (Mar. 9, 2020).

expected course of borrowing, "more experienced borrowers predict exactly correctly on average." Of additional note, Allcott, et al.,[123] compared the relative success of actual payday-loan borrowers at anticipating how long it would take to repay their loans with the predictions of a group of experts consisting of payday-lending practitioners and academic economists who study related issues. They found that while actual payday-loan borrowers underestimated their future borrowing by just 4 percentage points (all among less experienced borrowers) the group of "experts" predicted that payday-loan borrowers would underestimate their future borrowing by 30 percentage points. This suggests that experts hold a much dimmer view than is warranted of the ability of payday-loan customers to understand their needs and pursue available solutions. To the extent these experts' views are representative of the views of regulators and other policymakers, their inaccurate stereotype of the low sophistication, rationality, and intelligence of payday-loan customers, could make those authorities overoptimistic about their ability to identify policies that will improve consumer welfare by overriding the choices of those they claim to be protecting

[123] *See* Alcott, et al., *supra* note 122.

4. The supply of consumer credit

Chapter 2 of this report discussed how credit use, referred to today as "consumer credit," has been widespread in the domestic population for at least a century and especially since World War II. Chapter 3 then examined how economic theory and evidence over this time shows that mainstream consumer-credit use does not demonstrate just profligacy or irrational short sightedness as some observers have on occasion believed. Rather, individuals employ credit for many reasons but most often for asset purchases or response to emergencies, providing a return over time together with useful change in timing of inflows and outflows. Credit use is influenced by life-cycle stage, where younger individuals and households are more likely to show credit demand than older ones.

The change in timing of spending allows individuals to undertake purchases of assets or alleviate costs of emergencies while using the goods or services purchased. This avoids paying for more costly substitutes or doing without for some period that could be lengthy and expensive. But none of the chapters so far has included discussion of the credit-generating process itself and how production costs influence the supply of consumer credit. Following the discussion in this chapter and in Chapter 5, Chapter 6 then looks in more detail at background and concepts of regulation and what regulation has meant for consumer protection in the credit area.

Concerning credit supply, it is easy enough to see at the outset that most consumer credit is not forthcoming either from family members or other individuals, although this sometimes happens. Rather, modern consumer credit is mostly sourced by financial institutions, but this is not the complete story either.

Banks and other financial institutions are not the ultimate suppliers of funds they lend. Instead, they function as "financial intermediaries" because the funds advanced to consumers are mostly not the institutions' own. They obtain funds from savers, typically also individuals but also from other intermediaries that obtain funds directly from the ultimate savers. Financial institutions such as banks and credit unions but also many others pool the savings of millions of individuals and lend them productively to businesses, governments, and consumers. In fact, even if not widely understood among the public this way, those with the funds are lending their funds to the banks or other financial intermediaries that then pool the funds and lend them further to businesses, governments, and other consumers. This process of lending by the intermediaries to ultimate borrowers generates the revenues for them to provide a return to ultimate funds providers. In the transfer process from ultimate savers to ultimate borrowers, the intermediaries provide a number of important services to be discussed here further.[1]

This chapter contains four sections: First, it focuses on where benefits arise in the funds-transfer process. It turns out that benefits accrue to both the funding and lending sides of the transfer. Second, the chapter turns to what produces costs, discussing more specifically what causes costs on the lending side.

The third section of the chapter concentrates on available empirical information on production costs of lending. It especially examines information about costs of producing small-dollar traditional installment loans from finance companies, an area where statistical information is available, but also on how these costs compare with other intermediaries. The fourth section focuses on how costs lead to charges to borrowers. Truth in Lending provides for disclosure of these charges in the form of consistently calculated finance charges and Annual Percentage Rates on many consumer credit transactions.

4.1 Financial Intermediation

Consumer credit provided by financial institutions, like any other good or service used by consumers is the end product of a production process. Producing consumer credit involves transfer of funds from savers who have them to borrowers who desire to use more resources now than they otherwise would have immediately available. As outlined in the previous chapter, borrowing provides current access to household goods and services that provide investment returns or alleviate costs due to emergencies. The important point is that borrowers can save for the purchases through loan repayments while using the goods and services, thereby avoiding doing without or paying for expensive alternatives during the saving period. As ultimate sources for the loans, credit users employ saved resources made available by individuals through financial intermediaries.

[1]For early discussion of the role of financial intermediation, *see* JOHN G. GURLEY AND EDWARD S. SHAW, MONEY IN A THEORY OF FINANCE (1960). There is lengthier discussion than here with more references about the financial intermediation process for consumer loans in THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI CONSUMER CREDIT AND THE AMERICAN ECONOMY (2014), Chapter 5, which a few parts of the following section of this chapter draw upon.

This raises the interesting question: Who are the savers providing the saved resources? Examining the Federal Reserve's "Financial Accounts of the United States" series shows that while some resources arise from business and government saving, the bulk of saved funds in the economy arise in the large household sector.

Household providers of funds make them available to financial institutions in a variety of ways. There is little doubt that individual providers of funds would rather do so through institutions than directly to individual borrowers. Funds provision through institutions includes consumer transaction accounts with banks and credit unions (checking and money-market accounts), time accounts (savings accounts and CDs), life insurance reserves with insurance companies, pension rights and other retirement assets with pension funds (including individual retirement accounts, or IRAs), direct securities purchases (stocks and bonds), and purchase of mutual fund shares. The Federal Reserve's "Financial Accounts of the United States" shows the household sector had supplied more than $95 trillion to financial markets and institutions through ownership of financial assets as of the end of 2019, mostly through financial intermediaries.[2]

Some of the funds providers are wealthy individuals, but financial asset holding is much wider than just the wealthy. Often the ultimate lenders are the same individuals who are the ultimate borrowers, like the individual in Chapter 3 who borrowed $35,000 on an auto or truck loan but who also had $35,000 in a savings account or IRA, or in a 529 plan for college education of children. Much of the accumulated savings of the household sector, like retirement reserves, is held in much less liquid form than the consumer credit that households obtain from institutions as loans for purchases.

The most recent Survey of Consumer Finances shows that about 98 percent of households had some sort of transaction or savings account in 2019 (including some with prepaid debit cards or government benefit cards). Transactions and savings accounts are important sources of funds for lending by banks and credit unions. Other kinds of financial assets include certificates of deposit (CDs), held by 8 percent of households; savings bonds, by about 8 percent; directly held stocks, by 15 percent; investment funds (for example, mutual funds), by 9 percent; various kinds of retirement accounts, by 50 percent; and cash-value life insurance policies, by 19 percent,

[2] *See Financial Accounts of the United States*, until recently called the *Flow of Funds Accounts*, available since 1946 and found in Federal Reserve quarterly statistical release Z1 (https://www.federalreserve.gov/releases/z1/default.htm).

among other classes of financial assets. Mean and median holdings of financial assets among all households with financial assets were $364,000 and $25,700, respectively.[3]

Throughout the discussion of financial intermediation that follows, it is worth keeping in mind that the intermediation process must benefit both household-sector savers and borrowers if it is to exist as a method of transferring funds. Intermediation must benefit both sides of the transfer process by providing better risk-adjusted returns on savings (including safekeeping and accounting services) and reduced costs for borrowers, or the transfer process would not take place or would flow through other channels not involving intermediaries.

In theory, households could bypass financial intermediaries and make loans directly to other consumers (through platform lenders or not) to purchase houses, cars, or other goods. Peer-to-peer lending does exactly this. But very few households have the resources, acumen, or desire to provide the services of transferring funds from savers to borrowers. Typically, the funds used in loans are much different in form and amount than the funds acquisitions. Loans require underwriting, monitoring, collecting, and bearing default risks. As a result, most individuals prefer to lend money to a bank or other financial intermediary, which does have the expertise and resources to bear these costs and risks. In turn, the institutions pay interest and provide other returns on the accounts of these consumers to compensate them for their funds.

From time to time through the history of modern consumer credit, entrepreneurs or policy commentators have suggested a preference for direct person-to-person or peer-to-peer (PTP) lending, avoiding intermediaries. Recent examples include internet lending platforms such as Lending Club that bring funds sources (investors) together with borrowers for a fee of some kind. So far, however, it seems that such lenders are unlikely to replace large-scale financial intermediation due to the services that intermediation provides, unless the cost of providing intermediation services are too high for the revenues generated. Nearly all consumer lending takes place through intermediaries. On account of the importance of these intermediation services, including account and risk management discussed further below, active PTP lenders may well evolve into intermediaries and some appear headed in that direction. Indeed, several prominent online platforms that started out as PTP lenders have transitioned to offering loans in partnership with a traditional financial intermediary.

It is often not appreciated that this process of pooling consumer savings by financial institutions to put it to work as investment capital is particularly valuable to low-income consumers.

[3] Neil Bhutta, et al., Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances, FEDERAL RESERVE BULLETIN, p. 16 (September, 2020).

Wealthier consumers could, again in theory, engage in peer-to-peer lending more easily, or invest significantly in direct financial assets such as stocks and bonds to earn a return. Lower-income consumers, by contrast, typically are less likely to use those investment products. Moreover, returns to them from depository institutions like banks and credit unions in the form of ready funds-transfer services and safety through FDIC insurance can be very important. These useful services are available even in times like the present when interest paid on deposits is low.[4]

Overall benefits of intermediation for savers that almost seem obvious upon reflection are worth considering further. Financial intermediation provides returns to savers of a variety of sorts, some implicit to the point of sometimes being overlooked and others more explicit.

Among the implicit returns to savers is one already mentioned, the ready transferability of funds, often immediately for transactions accounts. Customer-directed transfers can take place through a nationwide and worldwide payments system using checks, debit and credit cards, and automated clearing house (ACH) transfers. Another is safety, including FDIC insurance for bank deposits and required public disclosures and fiduciary requirements for other institutions. There also are such important conveniences for consumers as instantaneous record keeping and annual preparation of necessary tax statements.

Returns are often more explicit on some financial assets, like interest on CDs or bonds that financial institutions issue, but there are also more kinds of less visible explicit returns. For instance, insurance companies use funds from policy premiums for investments that lower the overall insurance premiums for the insurance coverage. Likewise, anyone fortunate to have a defined-benefit pension receives a return from the investments of the pension fund. Such returns are even more readily visible for pension funds in the form of 401(k) plans and IRAs. Individuals with these plans typically count on the long-term investment returns of the plans to provide for their retirement years.

It is possible for individuals to manage their saved resources themselves, but many prefer professional management. The very wealthy may be able to manage financial assets well due to their experience, or they can hire financial managers. These possibilities are less probable for middle-class households and especially for lower-income families. These households are

[4]An analysis of one community bank found that 83 percent of the dollar balances in the bank's checking account were held by just 15 percent of the bank's customers, yet those with higher balances were paid only marginally higher rates of interest, if any, compared to those with much lower balances. *See* G. Michael Flores and Todd J. Zywicki, *Commentary on CFPB Report: Data Point: Checking Account Overdraft*, GEORGE MASON UNIVERSITY LAW AND ECONOMICS RESEARCH PAPER SERIES, No. 14-45 (July 16, 2016), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2499716.

especially likely to find professional management services provided by financial institutions useful. As indicated, individuals could pool savings and find borrowers to provide a return on these savings without intermediation by financial institutions, but evidence and even imagination describes many instances where this could be intolerably risky for individuals, especially lower-income households without much margin to spare.

In providing their services, financial institutions produce distinct financial products for market participants: savers, borrowers, or both. For example, banks and credit unions produce products for both savers (in the form of deposit products checking accounts, interest-earning savings accounts, and CDs) and for borrowers (loans). Because they provide financial products for both end points in the transfer process, banks and credit unions consequently are able to fund much of their lending with "internal funding" from their own products on the deposits side. It should be clear enough that the frequently used term "internal funding" is a bit of a misnomer, however, since the funds actually are borrowed externally from customers in the form of deposit products. They just often pass from ultimate source to use internally within the same institution.

Other intermediaries may focus more on one side of the process or the other, at least in terms of numbers of customers. For instance, consumer-oriented finance companies provide mostly lending products. They rely on obtaining funds for lending to their customers from other intermediaries, such as life insurance companies and pension funds.

These funding sources for finance companies are the ones that obtain the funds from households. Life insurance companies gather premiums from many policy holders and often lend the proceeds to other intermediaries in financial markets, including consumer finance companies that lend directly to individuals. Pension funds that obtain retirement savings from individuals or their employers also lend to other lenders such as consumer finance companies. Thus, there may be more than one intermediary between savers and borrowers, in this example insurance companies or pension funds lending to finance companies that lend to consumer borrowers. In this example, intermediaries provide services for other intermediaries involved in the process of transferring funds from ultimate savers to borrowers.

All of this involves expenses. Even "internal funding" by banks and credit unions is not without expense, of course. Although interest rates that depository institutions pay depositors currently are not very high, depositories still must maintain expensive operating and accounting systems to acquire and manage these funds. This may sometimes entail expensive branch systems with personnel costs, and accounting, control, and regulatory costs. Then there also are the actual lending costs for these institutions. They include establishing and maintaining branches, credit card systems, and other lending channels, as well as regulatory costs there too.

Institutions with presence primarily only on one side of the transfer or the other, like life insurance companies and pension funds on the savings side and consumer finance companies on the lending side, still have expenses associated with producing these products. At a minimum, all financial institutions have expenses associated with funds acquisition, recording, protection, and management. As lenders, there also are costs of lending and risk, and there are regulatory costs on both sides.

4.2 Costs of Lending

It quickly becomes clear enough that all intermediaries must contend with the costs of undertaking their businesses. It is also worth remembering that through economies of scale and specialization, financial intermediaries are able to perform the functions of funds transfer from savers to borrowers in financial markets at a lower cost than individuals could do on their own.[5]

This highlights an important point of the previous section that is worth emphasizing again: The transfer of funds is not from financial institutions' functioning as "them" to "us," but rather from individual consumers who have resources to those who need them, benefitting both sides of the transfer. Consequently, both sides benefit when the transfer is made as efficiently as possible, that is with the least possible cost caused by the transfer itself. Competition is an important element in enhancing efficiency and minimizing unnecessary private transfer costs, and so is efficiency in regulation. Inefficient, or unnecessary, funding and lending procedures and/or regulations do not benefit either side.

What then, more specifically, are the services that intermediaries provide on the lending side that produce costs, services that ultimate providers of funds do not typically want to provide themselves? More specifically than discussed above, they are: (1) information processing and underwriting, (2) risk intermediation, (3) monitoring, (4) temporal intermediation, and (5) size intermediation. Consider each of these in turn.

4.2.1 Information processing and underwriting.

This need arises from the uncertain performance of prospective borrowers who may in the future be unable (or unwilling) to pay as agreed. This possibility requires the lending institution to collect and evaluate information that provides a prediction on the likelihood that the borrower will repay so that the lending institution will be able to repay its own funds providers.

[5]See George J. Benston and Clifford W. Smith, A Transactions Cost Approach to the Theory of Financial Intermediation, JOURNAL OF FINANCE (May 1976).

The information typically includes evidence of the borrower's ability to repay, such as the adequacy and stability of current and future income, assets, and other debts. It may also include evidence of the borrower's performance on previous loans from the same or other lenders. By collecting and evaluating information from many past experiences, financial intermediaries are able to develop expertise and even sophisticated statistical systems for predicting prospective borrowers' likely behavior, a process generally referred to as credit underwriting.

There is no doubt that financial intermediaries know much more about underwriting and how to lend than typical individual consumers who have resources available to lend. Most consumers would rather place their available cash or retirement reserves in a financial institution with information systems than lend the funds directly to other consumers themselves. There also can be no doubt that lenders have consistently attempted to bring cost-reducing technology to bear on this business problem, leading to electronic and even automated or semi-automated systems for information generation and credit evaluation when possible.

4.2.2 Risk intermediation

This service arises from the ability of lenders to make many loans and diversify across many borrowers and different types of borrowers. Very few, if any, government, business, or individual borrowers are able to borrow without exposing a lender to some risk of default. Regardless of income, wealth, or assets pledged as collateral, any consumer borrower may have difficulty repaying debt as a result of a loss or reduction in income, sickness, accident, divorce, pandemic, legal judgment, or some other hardship. But if the risks arising from such hardships are not highly correlated across individual consumers, a lender can reduce risk by simultaneously lending to many consumers. Harry Markowitz showed that for any given expected return, diversification can reduce risk in a portfolio of securities if returns are not perfectly correlated.[6] With others, he received the Nobel Prize in economics for developing his important early insights in this area. This general concept is now discussed in every textbook on financial markets. Unfortunately, intermediation of risks does not imply elimination of losses. Losses due to unforeseen contingencies are going to arise regardless of quality of the underwriting. Spreading of risks by intermediaries that make many loans works to keep them under control and manageable.

[6] Harry Markowitz, *Portfolio Selection*, JOURNAL OF FINANCE (March 1952).

4.2.3 Monitoring

Along with underwriting and risk spreading, lenders also monitor borrowers' performance in order to manage risk. In consumer lending, the payment process provides the primary means for monitoring. Consumer loans typically require periodic payments of interest and principle. In closed-end (that is, fixed-contract) loans, the payments are usually regular periodic amounts for a fixed length of time, which fully amortize the loan. In open-end loans (revolving credit like credit cards), the payments may be largely at the borrower's discretion, with only a minimum amount being required but still some amount.

In either case, timely payments provide evidence of the borrower's continued ability and willingness to repay. Late payments are an indicator that a problem may have arisen. Specific charges imposed for late payments are an attempt to discourage such behavior (and not only for the purposes of increasing revenue as sometimes believed, although late fees may help cover costs associated with late payments as well as discouraging them). Lenders also attempt to contact borrowers who are late to seek resumption of payments and assess likelihood of future repayment problems. If the problems are serious, a lender may arrange for workout or a resolution. When a resolution is not feasible, a lender may liquidate or foreclose on collateral, if available. A lender may also obtain periodic credit reports from a credit reporting agency, popularly known as a "credit bureau," to monitor the borrower's behavior and prospects.

For example, installment loans like auto or cash loans create a long-term obligation to be paid in monthly installments for an established period of time. Under the loan payment schedule, if the borrower makes all the payments on time for the scheduled duration of the loan, the loan will be amortized and paid in full. Of course, simply establishing a payment schedule that will amortize the loan does not mean that the borrower will actually adhere to that schedule, making monitoring a requirement.

Sometimes there are more costs. For instance, sometimes borrowers will be unable or unwilling to make one or more payments. This will require the lender to try to contact the borrower to try to collect the payment or to negotiate for an extension or reworking the loan. This can be a labor-intensive and expensive process, sometimes requiring employees to make repeated telephone calls to reach and negotiate with a delinquent debtor. Each of these contacts takes time and effort that increases the costs of monitoring and servicing loans.

Credit bureaus may mitigate such costs to some degree, but they do not solve them. In a conference presentation at the Federal Reserve Bank of Philadelphia, businessman Gary Phillips discussed costs at one of the larger remaining traditional installment small-loan lenders (not to be confused with a payday lender). He noted that while credit bureau scores are important, an employee's judgmental analysis is a critical input in underwriting low credit-score applications.

Employees must assess the applicant's ability to pay and determine a set of loan terms (loan amount and monthly payment) that an applicant can easily afford to repay.

Further, sometimes low-score or even higher-score borrowers who are on a self-amortizing installment-loan schedule that pays in full at a specific maturity do not necessarily remain on schedule without reminders. This process is costly because it is especially labor intensive. Despite efforts by lenders of this kind to make monthly payments easily affordable, a significant share of borrowers makes late payments. Employees spend considerable time monitoring and attempting to contact delinquent borrowers, making arrangements for payment, and resolving problems. Phillips also provided break-even APRs for different loan sizes based on the company's costs that take all this into account. His data showed an inverse relationship between necessary APR and loan size, and the levels of APR at each loan size were broadly consistent with the National Commission on Consumer Finance's (NCCF's) estimates in 1972.[7]

From this discussion, it is easy enough to see the underlying cause of the inverse statistical relationship: First, costs of functions like information processing and much of the monitoring function through taking payments are relatively similar for small loans and larger ones. Therefore, they are relatively more per loan dollar for the smaller loans. Then, labor-intensive actions involving reminders, collecting loans, and bad debts likely are going to be higher for smaller loans, due to riskier borrowers. As indicated, the NCCF also found this inverse relationship between loan costs per loan dollar and size of loans, and it is discussed further later.

4.2.4 Temporal intermediation

This function arises from frequent preference of individual borrowers for different terms to maturity than savers. Borrowers financing the purchase of expensive consumer durable goods or housing purchases, for example, may prefer a relatively long term to maturity, which produces smaller monthly payments. On automobile loans, this consideration can lead many borrowers to choose terms to maturity of five years or even longer. Housing loans can extend for 30 years.

But many savers prefer a shorter term to maturity for their savings than borrowers prefer, or even immediate access to their savings. Intermediaries can change maturities, even using transactions account payable immediately as funding for mortgage loans extending for 30 years. Firms and consumers want a place to keep temporary surpluses until they are needed for payments or until sufficient funds are accumulated for investment. Consumers may also prefer a

[7] Presentation by Gary Phillips to the Federal Reserve Bank of Philadelphia Consumer Finance Institute (2013). Accessed at https://www.philadelphiafed.org/-/media/consumer- finance-institute/payment-cards-center/events/conferences/2013/small-dollar-credit/papers/phillips.pdf?la=en

short term to maturity or immediate access for precautionary reserves held for emergencies. In contrast, pension rights, life insurance reserves, and IRA assets may have maturities much longer than consumer loans.

Individual savers do not normally withdraw all savings simultaneously; however, nor do they all add to their savings at the same time. Pooling the savings of many savers enables financial intermediaries to maintain sufficient funds to lend on a longer-term basis while satisfying the needs of individual savers to withdraw savings on short notice.[8] Financial intermediaries also normally are able to anticipate the need for funds to cover withdrawals, and they may raise additional funds to meet needs in wholesale money markets.[9]

4.2.5 Size intermediation

This refers to how financial intermediaries can raise funds in small or large amounts but then lend them in the opposite size extreme. For instance, banks commonly acquire small amounts of funds from savings or checking accounts and then lend them as larger automobile, mortgage, and business loans. Some financial institutions may also raise large amounts of funds at one time in capital markets to make small loans, such as finance companies that raise large amounts in national or international bond and commercial paper markets to fund smaller loans to consumers and businesses. Much of this funding comes from other intermediaries like life insurance companies and pension funds. Individuals lending to one another are not likely going

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[8] Recognition of this concept led to the beginning of deposit banking in England in the seventeenth century. At that time, people deposited gold at London goldsmiths for safekeeping. Goldsmiths soon came to realize that they did not need to hold the entire amount of deposited gold to redeem deposits and began to lend part of the deposited gold. Thus, goldsmiths became financial intermediaries. Furthermore, goldsmiths functioned essentially as banks when goldsmiths' receipts became accepted as a means of payment as well as than the gold itself, because the receipts were more convenient to exchange than the deposited gold. For further historical discussion, *see* W. T NEWLYN, THEORY OF MONEY (1962).

[9] Occasionally financial intermediaries experience sudden unexpected large withdrawals because of concerns about an intermediary's own solvency, concerns about solvency of other similar intermediaries, or changes in macroeconomic conditions which shift savers' preferences among savings instruments. Financial intermediaries that raise large shares of funds from short term savings instruments, especially accounts like transaction/checking accounts that can be withdrawn on demand, are potentially vulnerable to such events. Today, central banks like the Federal Reserve System and guarantee agencies like the FDIC mitigate such problems, as seen recently in both 2009 and 2020. Concerns about the solvency of a particular bank, or the banking system as a whole, have caused bank runs in the past, a large part of the reasoning behind establishing the central bank and federal deposit insurance in the United States.

Increases in the level of market interest rates have also sometimes caused savers to withdraw funds from banks and savings institutions more gradually and shift them to direct US Treasury securities, a process called "disintermediation." Such disintermediation occurred from time to time during the period from 1936 to 1986 during periods of high interest rates. At the time, interest-rate ceilings on deposits (called Regulation Q) prevented depositories from raising rates as market rates rose. After this time, removal of interest rate ceilings on consumer deposit accounts dramatically reduced the incidence of disintermediation.

to be able to undertake these activities for themselves, or want to undertake them, and this encourages the growth of intermediaries to provide them and facilitate the flows of funds from savers to borrowers.

But intermediation is not free, and there are personnel, systems, risk, and regulatory costs associated with providing the services of financial intermediation. As indicated, costs arise in various ways in the intermediation process outlined above, and different institutions use different approaches to mitigate them and run their businesses.

For example, commercial banks incur costs from their extensive infrastructure used both for acquiring funds through deposits, often of small amounts, and distributing the funds by making loans typically in larger sizes. In recent decades, they have acquired funds and loans through branching systems, but they also have moved to reduce costs where possible by substituting electronic access for branches and branch personnel. Historically for business reasons, and more recently also due to regulation, banks have tended toward the lower end of the lending-risk scale. Lower risk, together with larger loans, has tended to place these institutions among the lower-cost providers of consumer credit. As discussed in Chapter 3, theorists/empiricists Juster and Shay included them among those they referred to as "primary lenders."[10]

In contrast, consumer-oriented finance companies have used a different business approach. Precluded in most places from taking deposits from the public, finance companies have acquired most of their funding for lending from other intermediaries including banks, insurance companies, pension providers, mutual funds, and other institutional lenders in national and international capital markets. Many of them are publicly held stock companies that raise capital through issuing equity shares. Others are funded by private investment, such as FinTech companies funded by venture capital investment, at least initially. This has made funds acquisition for them considerably less labor and infrastructure intensive than for banks, lowering their costs on this side of the intermediation process.

But their operations in riskier parts of the lending markets have tended to raise their costs of monitoring and credit losses relative to banks. They have often made smaller loans on average than banks, tending to raise operating costs per loan dollar (mentioned above and discussed further later). They also typically have operated at lower "leverage" ratios than banks. This means they usually have a lower proportion of market borrowing compared with ownership capital than banks, and this could lower their return on equity capital relative to banks, other

[10] F. THOMAS JUSTER AND ROBERT P. SHAY, CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION (1964).

things equal.[11] Consumer finance companies often are in the range of "secondary lenders" discussed by Juster and Shay.

As this quick examination shows, costs on the lending side of financial intermediation arise from a number of groups of cost-causing activities necessary at this end of the financial intermediation process. Different institutions face these challenges in different ways, leading to different kinds of institutions.

Continuing to become more specific as this narrative proceeds, it is common to classify lending costs into two groups for further analytical purposes: operating costs and non-operating costs, each with subcomponents. The categories and subcomponents seem obvious upon reflection, and they differ across classes of institutions due to the nature of their businesses. Recognition of kinds of lending costs is very old.[12]

Operating Costs

Operating expenses include costs of originating loans, processing payments, collection of delinquent accounts, and bad debt expenses. Non-operating expenses include taxes, interest expense arising in funds-borrowing activities, and a return on the owners' equity share of the advance to the borrower. Although economic theory, as well as experience, suggests that intermediation lowers the overall cost of the transfer of resources from ultimate savers to borrowers, it is still true that the prices charged for loans must fully cover operating and non-operating costs of the transfer process. Otherwise, the institution cannot remain in business and provide the services of intermediation.

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[11]Capital-market lenders to them have forced this lower-leverage approach (lower proportion of borrowed funds) due to their higher risk in the absence of FDIC insurance on the capital-market funds. Other things equal, this would mean higher funding costs and lower profitability for finance companies for the same revenue and other costs. But "other things equal" is a very large theoretical issue for the importance of financial structure on profitability, even aside from the requirement of same revenue and other costs for full and proper comparison, but there is no need to go further into this question here. The financial structure issue involves the general theoretical area known as the "Modigliani-Miller Theorem," a highly technical and mathematical area of financial economics. Professors Franco Modigliani (Massachusetts Institute of Technology) and Merton Miller (University of Chicago) received the Nobel Prize in economics in different years for a variety of contributions to financial economics, including this early joint work at Carnegie Mellon University.

[12]For instance, economists have long recognized that lending costs involve more than just return for payment later (interest or the time value of money) and risk. *See*, for example, IRVING FISHER, THE RATE OF INTEREST: ITS NATURE, DETERMINATION, AND RELATION TO ECONOMIC PHENOMENA 88, 209 (1907)); ALFRED MARSHALL, PRINCIPLES OF ECONOMICS 8TH ED. 488-9 (1920); and EUGEN VON BÖHM-BAWERK, CAPITAL AND INTEREST, A CRITICAL HISTORY OF ECONOMICAL THEORY 7 (1922). In their *History of Consumer Credit*, Gelpi and Julien-Labruyere trace this understanding to the middle ages where medieval religious scholastics allowed for interest in four cases: *lucrum cessans* (deprivation of the advantages of a different advantageous investment (forbearance)), *damnum emergens* (suffering damages due to risk such as late payment), *stipendium laboris* (operating costs), and *ratio incertidudinis* (other risk costs). *See* ROSA-MARIA GELPI AND FRANCOIS JULIEN-LABRUYERE, THE HISTORY OF CONSUMER CREDIT, 37 (2000).

To originate a loan, a lender must solicit customers through advertising or lead generation, take applications, verify and evaluate information in applications to determine whether to grant credit and how much credit to grant, manage aspects of any collateral, prepare documents, disperse the funds, take in and account properly for payments, and comply with regulations. Many of these activities can be labor intensive, and some often require branch locations for certain kinds of credit. The number of branches and their operating hours vary according to the characteristics of the customer base.[13] In addition, all the lending and collecting activities must be done in compliance with a variety of sometimes complicated legal requirements, costs of which do not always fall with equal relative weight on all institutions.

Loan approval rates vary by industry, yet each application must be subject to at least some initial scrutiny, and oftentimes extensive scrutiny, before a final determination whether to extend credit is made. Because the norm in most consumer finance industries is not to charge an application fee, this means that the costs of processing applications for those who eventually are declined must be covered by those whose loans are approved. This cross-subsidization is analogous to the truism that losses on loans that default must be recouped in the prices charged to those whose loans are paid. As indicated, all this must be done in compliance with a variety of sometimes complicated and costly legal requirements.

After origination, further operating costs are associated with consumer lending. Closed-end credit is typically repaid in regular installments, which involve the processing of a series of payments over the term of the loan and entail recordkeeping. In some cases, payments are made electronically, either through a preauthorized debit to the consumer's deposit account or by the customer through the internet, but many payments continue to be made by check. In either case, repayments involve specialized equipment and/or employees. Electronic and internet systems require computers, software, and operators. There also are call centers or other operating systems to handle questions, problems, and disputes.

Open-end credit involves multiple extensions of credit and repayments. As most open-end accounts involve frequent, relatively small extensions of credit, processing is highly automated. Nevertheless, employees perform several processing activities, and the necessarily extensive processing and communications systems are costly ongoing, requiring large data centers. Lenders typically have systems to authorize and process credit extensions automatically, although sometimes an employee may authorize an extension that exceeds a borrower's credit

[13] For example, surveys of payday loan borrowers reveal that store outlets are plentiful in many places because many potential customers have limited transportation (for instance, they may live in cities and not own a car). Also, some customers value longer hours than available at banks or credit unions because many of them are hourly shift workers who are unable to visit financial institutions during normal business hours.

limit or an increase in the credit limit. Lenders monitor open-end extensions for fraud using automated systems, but fraudulent extensions are often detected by the borrowers when they receive their periodic statements. In these cases, employees in call centers record, evaluate, investigate, and act upon the information as needed, but the call centers are expensive to operate. Payments may be processed electronically, but many payments on open-end accounts are made by check and even automated equipment must be supervised by employees. Employees also process account status and billing questions; replacements for lost, stolen, or damaged cards; name and address changes; and requests for account closings and responsibility changes due to divorce or death.

An important characteristic of these underwriting and processing activities is that they occur because an application is taken and a loan made and, other things equal, they are unlikely to vary a great deal by the amount of credit involved. As a practical matter, they approximate fixed costs per loan.

For instance, costs of making a $50,000 loan undoubtedly are higher than making a $1,000 loan, but they are not going to be anywhere near 50 times as much. The operating costs associated with compensating employees for their time taken in underwriting and for rent, utility payments, making a phone call to a delinquent customer, or some machine or employee opening the mail and entering the amount on the check into the computer under the customer's account do not depend upon loan amount. They are all essentially fixed costs that either do not vary with the number of loans made, or variable costs that do not scale proportionally to the size of the loan. This characteristic is also present in other activities, like accounting and record keeping, which give rise to operating costs. Many legal costs that arise from compliance with regulatory requirements are especially likely to have such characteristics.

Further considering costs by loan size, the costs associated with making a smaller loan can even be more expensive in absolute terms and not just relative terms, when compared with larger loans of different types. For example, auto loans made to low-risk borrowers to finance new cars will require some initial costs in loan origination. Many of those costs will be standardized, routine, and automated, all of which reduces the costs of making that loan. And after the loan is originated, it may require relatively little in ongoing servicing costs, especially if the borrower pays each month through an ACH or other electronic transactions.

By contrast, auto loans made to higher-risk borrowers to finance less expensive used cars will often involve more heterogeneous borrowers and collateral. The borrowers can have more idiosyncratic credit characteristics. Loan approval rates might actually be lower in these cases than for larger auto loans to prime borrowers. Customers might be more likely to pay by check or even in cash instead of electronic transfer, incurring costs associated with opening and processing the payment. More important, these loans to higher-risk borrowers will, on average, require more ongoing monitoring and collection activities, as employees exert time and effort to contact delinquent borrowers and initiate collection or loan modification processes, all of which involve costs. Finally, loss rates may be higher, costs which must be spread as part of the costs of other loans. All this suggests smaller loans might actually produce higher absolute costs per loan made than larger loans, not just relative costs per loan dollar.

Consequently, the portion of the finance charge just to cover operating and processing expenses on a large loan is likely to be less relative to the loan amount than on a smaller loan, possibly much less. This means, in turn, that Annual Percentage Rate (APR) of charge is going to be less on a larger loan than on a smaller one to cover these costs, other things equal. This is explored further later in the chapter.

In addition, as indicated, some borrowers do not always make timely payments, and this varies by sector of the lending industry. A lender must monitor loans for late or delinquent payments. While identification of delinquent accounts and initial contact with the borrower may be automated, an employee may eventually have to contact a delinquent borrower to seek payment. Depending on circumstances, the employee may remind the borrower of an overdue payment, make repeated contacts to receive payment, negotiate a new schedule for repayment, or decide to turn a delinquent account over for more serious collection efforts like lawsuits. Employees must document promises to pay, payment plans, and accountholder actions or circumstances relating to the delinquency. Employees may decide to pursue legal remedies such as recovering and selling assets taken as collateral. While some accounts with late payments and delinquencies may eventually be paid in full, processing such accounts can be quite costly. Other accounts are eventually charged off. For many lenders, losses due to charge-offs are a significant operating cost of lending. These costs all tend to be higher per loan dollar on smaller loans than on larger loans.

Losses on loans that do not repay are a concern to all lenders and can be a significant part of operating costs for some of them, especially those lending in subprime sectors of the lending markets. Losses tend to be quite low for mortgage lenders lending to prime risks, which is due at least in part to the intensive (and costly) underwriting procedures of mortgage lenders to differentiate among risk cohorts. The Federal Reserve statistical series shows very low loss rates on mortgage loans at banking institutions recently, but loss rates had reached nearly 3 percent in late 2009.[14]

[14] *See* Board of Governors of the Federal Reserve System, "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks," quarterly statistical release. Available at https://www.federalreserve.gov/releases/chargeoff/.

Consumer-lending loss rates tend to be higher than bank mortgage lending, depending on the type of institution and its market sector, type of loan, and overall macroeconomic conditions. For instance, loss rates on consumer loans at banks were 1 percent in the fourth quarter of 2019, down from more than 3 percent in 2009 as a result of the Great Recession at that time. The rate of bank losses on unsecured credit card accounts stood at 3.65 percent in the fourth quarter of 2019 and over 4 percent six months later. In 2009, loss rates on credit card accounts had exceeded 10 percent and reached 11 percent in early 2010. Loss rates on small consumer cash loans at finance companies also were high and are discussed in more detail in the next section of this chapter after first looking briefly at non-operating kinds of costs for lenders.

Non-operating Costs

Non-operating costs consist of cost of borrowed funds, income taxes, and return to equity funds. As discussed, much of the funding for consumer lending consists of borrowed funds, and the sources of borrowed funds also vary by the type of lender. Banks obtain by far most of their borrowed funds from customers' deposits. Because of deposit insurance, most deposits are risk-free to the depositor, and consequently are a low-cost source of funds. Banks also borrow funds at market rates in capital markets. Finance companies obtain borrowed funds from banks, the commercial paper market, and the long-term capital market where lenders include other institutions like life insurance companies and pension funds. The capital market is the largest source of borrowed funds for finance companies.

Significantly, the cost of borrowed funds per loan dollar is going to vary much less by loan size for a given lender than operating costs. When acquiring funds for lending, the first dollar acquired carries much the same interest charge as the ten-millionth dollar acquired or the billionth dollar, up to the ability of the lending company to acquire funds at all. This means that total costs still continue to loom larger per loan dollar for smaller loans than larger loans even when taking into account the interest costs of funds acquisitions for the loans. It also means that the size of loans made is going to be important in the overall cost structure of various types of lenders. More will be said about costs per loan dollar in the next section.

The residual after paying operating costs and non-operating costs like interest on borrowed funds and income taxes is the return on equity, which may be distributed as dividends to owners or retained in the firm. The return to equity compensates suppliers of equity capital for the funds they invest in the firm and the risk to which these funds are exposed. Like nonfinancial firms, banks and finance companies that do not provide a return on equity that the market for equity capital requires will shrink and eventually disappear. Credit unions depend on members' share deposits for nearly all their funding. Credit union share deposits, like bank deposits, are a low-cost source of funds. Unlike most other types of lenders, credit unions are cooperative, not-for-profit organizations. As such, their net income is not subject to income taxes or equity costs, but they still must cover operating and funding costs.

4.3 Measuring Lending Costs

Although all lenders are subject to operating and non-operating costs, this does not mean that the costs of all lenders and loans are the same. As indicated, operating costs in the form of salaries, expenses associated with maintaining places of businesses (rents, fixtures, supplies, communications, and utilities), and legal costs due to regulation all arise from the nature of lending. All lenders must pay for them, but the costs are going to loom larger per loan dollar for those making smaller loans.

In contrast, non-operating costs, especially costs of funds acquisition, also are important to all lenders, but they increase directly and equally per lending dollar acquired and used. Thus, they increase dollar for dollar as loan size increases and loom relatively larger as a proportion of overall lending costs per loan dollar as loan size increases. For this reason, they become an important reason that lenders differ. Different proportions of fixed operating costs and variable non-operating costs per loan dollar are an important reason some lenders are low cost and others high cost on an APR basis. It is worth looking at this differentiation further.

Consider the difference between a storefront cash installment-loan lender and an automobile finance company financing the sale of new automobiles. For discussion, the installment cash lender makes mostly $2,000 loans for one to two years; the automobile finance company makes loans of $20,000 and up for five years and more.

For the cash lender, the fixed part of the operating costs per loan dollar are going to be proportionately higher than for the auto finance company, making it a higher-cost lender than the auto finance source, even apart for any concern over differences in risk. For the auto company, interest costs of borrowing funds for lending in the amounts of tens of thousands of dollars per loan are going to be the predominate element of total costs. This is even truer for mortgage lenders.

Further consideration of this idea then shows, in turn, how total costs of larger-loan lenders are more sensitive to market conditions on funding costs than for small-loan cash lenders. Funding costs simply loom proportionately larger for larger-loan lenders. This phenomenon of greater sensitivity to funds cost is especially visible for mortgage loans where lending rates vary daily depending on current costs of obtaining loanable funds.

But it is the operating costs like salaries for making loans and providing reminder programs and collections, plus likely losses, that most affect the costs per loan dollar of the small-loan cash lender. As indicated earlier, their costs per loan may even be absolutely higher per loan on the smaller sizes due to risk and trickier underwriting, processing, payment reminders, and collection activities per loan on smaller loans. Auto and mortgage lenders are also subject to risk and losses but much less on average per loan dollar. In both cases, these lenders are secured with saleable collateral to limit losses.

Generalizing from this discussion and examples, lenders to consumers have different cost structures, and they differ because of them. These differences suggest that the charges they make for loans are going to differ as well. Consequently, it is worth looking more closely at the cost structures of various kinds of lenders, and in this we continue efforts of the NCCF. Like the NCCF, we do not have as much information as we would like, but some specific cost information has become available from time to time. The Taskforce recommends that scholars continue to study costs of lending, enlarging the availability of reliable cost information whenever possible. This will continue to improve understanding of lenders, how they compete with one another, and how changing costs also alter the services available to consumers over time.

Installment Cash Loans

We begin with more discussion of traditional unsecured personal installment loans. This is not because these loans are most important in economic impact; in fact, the entire personal installment loan market is small compared with products such as auto lending, credit cards, student loans, and mortgages. We examine installment loans in some detail in part because data on this industry have become available from time to time, but also because the NCCF Report focused on this industry, which gives the Taskforce a baseline for comparing changes over time.

Further, finance-company consumer lenders are appropriate for studying consumer lending in a statistical sense because they are single-product companies and do not require statistical cost allocations among products due to a multiplicity of products. Many finance companies focus almost exclusively on consumer loans without the cost-accounting difficulties associated with multiple-product institutions like banks. Their fund-raising side is managed by a limited number of headquarters personnel who undertake borrowing from other intermediaries in large amounts at one time. Unlike banks, most of their costs arise on the lending side. Following investigation of installment cash loans, we look at available cost information on other kinds of lenders.

The Russel Sage Foundation first examined lending costs at finance companies in the 1910s to inform its recommendations concerning rate ceilings, although its early cost work was not highly detailed.[15] Dauer (1944) and Smith (1964 and 1967) examined costs of consumer finance

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[15]See LOUIS N. ROBINSON AND ROLF NUGENT, THE REGULATION OF THE SMALL LOAN BUSINESS (1935), and Elizabeth Anderson, *Experts, Ideas, and Policy Change: The Russell Sage Foundation and Small Loan Reform,* THEORY AND SOCIETY (June, 2008).

companies from the 1930s to the 1960s.[16] In 1968, when it legislatively established the NCCF, Congress directed it to consider the functioning of consumer-credit markets for providing consumer credit at reasonable rates. This caused the NCCF to undertake extensive data-gathering exercises and to look at data in a number of ways. In the area of lending costs, it also engaged as a consultant professor George J. Benston of the University of Rochester, who was at the time the leading expert in the country on statistical cost studies of financial institutions.

In 1972, the NCCF reviewed the underlying costs of consumer lending at considerable length in its Chapter 7. The NCCF focused especially on consumer finance companies that primarily provide small cash loans to consumers, today known as traditional installment cash lenders. They extend relatively small amounts of credit on an installment basis to riskier consumers who might have difficulty obtaining credit elsewhere.

The NCCF found that break-even interest rates for credit from consumer finance companies needed to be quite high at small-loan amounts because of the great relative weight of fixed operating costs. Their analysts showed that break-even rates (APRs) declined steeply as loan amounts increased and eventually leveled off at larger loan amounts, as fixed operating costs are spread across ever-larger loan amounts. Concerning these costs and their effects on rates of charge, the NCCF summarized its findings as follows (page 145): "When rate ceilings are below the levels indicated [their estimated break-even rates], staff studies show that consumer finance companies can stay in business only by greater loan sizes, limiting their risk acceptance to more affluent consumers, and [by] maintaining large volume offices."[17]

For a part of its work, the NCCF used cost data assembled by professor Paul Smith of the University of Pennsylvania from nine large consumer finance companies that together accounted for about two-thirds of the receivables of consumer finance companies at the end of 1964.[18] Professor Smith had assembled the data as part of the consumer credit research project of the National Bureau of Economic Research (NBER) at the time, and the NCCF used it for its

[16]ERNST A. DAUER, COMPARATIVE OPERATING EXPERIENCE OF CONSUMER INSTALMENT FINANCING AGENCIES AND COMMERCIAL BANKS 1921-1941 (1944), PAUL F. SMITH, CONSUMER CREDIT COSTS 1949-1959 (1964), *and* Paul F. Smith, *Recent Trends in the Financial Position of Nine Major Consumer Finance Companies*, in JOHN M. CHAPMAN AND ROBERT P. SHAY, EDS., THE CONSUMER FINANCE INDUSTRY: ITS COSTS AND REGULATION (1967).

[17]Russell Sage Foundation analysts found similar experience. In an analysis of rate regulation in the early twentieth century, Nugent observed similar consequences in four states that lowered rate ceilings in 1929. The number of finance companies operating in these states declined, finance companies closed offices with smaller loan volumes, stopped making smaller loans, and illegal lenders (loan sharks) reemerged. See Rolf Nugent, *Three Experiments with Small Loan Interest Rates*, HARVARD BUSINESS REVIEW, (October, 1933). See ALSO ROBINSON AND NUGENT, *supra* note 15.

[18]See Smith (1967), *supra* note 16.

work in Chapter 7 of its *Report*. Professor Benston analyzed these data and another dataset with more lenders that he acquired from the National Consumer Finance Association, the trade association of these lenders. The NCCF also extensively analyzed the results of its data collection of amounts and types of consumer credit in use in 1971.

A passage in the NCCF's *Report* shows its interest in the relationship between production costs and the availability of credit (page 139):

> The staff's empirical evidence cited in preceding sections indicated that relatively low rate ceilings–ceilings which actually influence the observed rate-are typically associated with significant reductions of credit supply in affected state markets. In the finance company segment of the personal loan market, for example, it was estimated that [statewide] supply per family began to fall where rate ceilings averaged between 28 and 30 percent. Below an average ceiling rate of about 28 percent, between 60 and 70 percent of the interstate variation in supply is accounted for by rate ceiling variations and growth. Similarly, supplies of revolving credit per family are apparently below the national average where APRs on revolving accounts are less than 18 percent. As explained earlier, such curtailments may be expected to occur whenever rate ceilings impose a price insufficient to cover the costs of extending credit. This is, of course, a fundamental proposition that applies to the production and sale of any service or commodity: If the price is not sufficient to offset costs, including normal costs of capital invested, supply is curtailed unless subsidies in some form are provided. Therefore, it is necessary to explore carefully the costs incurred in extending credit for purposes of corroborating the [overall] availability findings and designing recommendations for appropriate rate ceiling.

In addition to the NCCF's basic statistical work on credit amounts available in the various states, professor Benston used the cost data to undertake econometric analyses for the NCCF. He used the Smith/NBER dataset to undertake review of revenues and costs of consumer lending and to analyze whether there were economies of scale in lending according to the size of lending offices. He used the National Consumer Finance Association dataset that included more companies to study economies of scale at the firm level and analyze the costs of lending on loans of different sizes. (From 1960 through 1989, the trade association undertook an annual data-collection effort involving its finance-company members.) Benston's studies were available to the NCCF in 1972 and later appeared in the NCCF's *Technical Studies* and in a series of publications in academic journals in the 1970s. His studies for the NCCF became the basic template for the later studies using newer data, modern econometrics approaches, and more flexible mathematical functional forms to study the same and similar issues.[19]

Analysts in the Federal Reserve Board's Division on Research and Statistics have twice updated the NCCF's findings on small-dollar installment loans from finance companies with newer data and newer mathematical functional forms, econometrics, and calculations. The first was in 1998, using 1987 data similar to that obtained by Benston for the NCCF in 1971. The second was in 2020 using information from the Board's 2015 survey of finance companies.[20]

Chen and Elliehausen reported findings from the 1998 and 2020 updates and compared them with estimates of lending costs available to the NCCF in 1972. Their Table 1 compared findings for aggregate revenues and costs for these largely single-product consumer lenders relative to their lending for data years 1964, 1987, and 2015 (see Table 4-1, below). In their introductory paragraphs, Chen and Elliehausen summarized the comparison for loan revenues, costs, and necessary break-even APRs on the loans: "In particular, this article examines the relationship of the loan amount and break-even annual percentage rates and the implications of this relationship for rates and credit availability. Findings suggest that despite many changes since 1972, the NCCF's [cost] conclusions are still valid today" (page 1).[21]

The evidence they reported shows that gross revenues of consumer finance companies from $100 of credit rose 1964-1987 (line 1 in Table 4-1). This reflects the increase in market interest rates generally during those years. Loan revenues per $100 of credit continued to rise 1987-2015, even though market interest rates declined during these years. This time the lending revenue effect per $100 of loans reflects smaller average loan size over those years. (The trend of market interest rates first upward and then downward over time is visible on cost of borrowed

[19] *See* George J. Benston, *The Costs to Consumer Finance Companies of Extending Consumer Credit*, TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, Volume 2, Number 1 (1975); George J. Benston, *Risk on Finance Company Personal Loans, JOURNAL OF FINANCE* (May 1977); George J. Benston, *Graduated Interest Rate Ceilings by Size of Small Consumer Cash Loans, JOURNAL OF FINANCE* (June 1977; and George J. Benston, *Rate Ceiling Implications of the Cost Structure of Consumer Finance Companies*, JOURNAL OF FINANCE (September 1977). See also Thomas A. Durkin, *Consumer Loan Costs and the Regulatory Basis of Loan Sharking,* JOURNAL OF BANK RESEARCH (Summer 1977), which analyzes another dataset collected for the National Commission on Consumer Finance using similar methodology. Benston developed the basics of the methodology in his studies of cost economies of scale of commercial banks in the 1960s, an issue related to banking competition.

[20] Thomas A. Durkin and Gregory Elliehausen, *The Cost Structure of the Consumer Finance Industry*, JOURNAL OF FINANCIAL SERVICES RESEARCH (February, 1998); Lisa Chen and Gregory Elliehausen, *The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board's 2015 Survey of Finance Companies,* FEDS NOTES (August 2020).

[21] Chen and Elliehausen sourced their Table 1 (Table 4-1 here) from data underlying a broader description and review of the 2015 finance company survey in Lisa Chen, Gregory Elliehausen, and Mark Wicks, *Survey of Finance Companies, 2015*, FEDERAL RESERVE BULLETIN, Table 10 (June 2018).

funds, line 4A of the table.) Borrowed-funds cost increased from $4.17 per $100 of receivables in 1964 to $6.05 in 1987 before falling off to $2.28 in 2015. It is noteworthy, though not surprising, that in all three years the cost of borrowed funds relative to $100 of lending looms small for these companies compared with operating costs.

TABLE 4-1: LOAN REVENUE AND COSTS OF TRADITIONAL INSTALLMENT, CASH LENDERS, SELECTED YEARS, (PER $100 OF RECEIVABLES)

	1964	1987	2015
1. Gross Revenues (Finance charges and other income)	21.40	24.89	29.09
2. Operating Expenses	12.73	15.16	20.74
2a. Salaries and Wages	5.60	6.52	8.77
2b. Other Operating Expenses	4.87	6.13	6.10
2c. Additions to Loss Reserves	2.27	2.11	5.87
3. Net Operating Income (Line 1 less Line 2)	8.67	9.73	8.35
4. Non-operating Expenses	6.34	7.51	4.40
4a. Cost of Borrowed Funds	4.17	6.05	2.28
4b. Income Taxes	2.17	1.46	1.27
5. Total Expenses (Line 2 plus Line 4)	19.07	22.67	25.19
6. Net Income (Line 1 less Line 5)	2.33	2.22	4.80
7. Notation: Average amount of receivables per account (dollars)	485	3103	2289

Source: Lisa Chen and Gregory Elliehausen, "The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board's 2015 Survey of Finance Companies," *Feds Notes*, April, August, Table 1.

The table shows that total operating expenses relative to credit (line 2) increased over time, due both to higher salaries and greater losses (lines 2A and 2C). Higher salary scales might well have been mitigated for these companies by greater efficiency through various sorts of office and lending automation over the years 1987-2015 but not relative to loan amounts, as average loan size decreased 1987-2015 (line 7).

The impact of the industry's taking on smaller, undoubtedly riskier, loans on average after 1987 is visible in losses relative to credit (line 2C). Despite these changes, net profitability per $100 of receivables varied relatively little over the period (line 6). Lower funding costs raised this measure in 2015, but return on assets for personal loan companies in 2015 was lower in 2015 than it had been in 1959 (not in table, see Chen, Elliehausen, and Wicks (2018), Table 10).[22]

Chen and Elliehausen then calculated loan costs by loan size using the methodology developed by Benston for the NCCF. They found that lending costs per loan rose as loan size increased in each of the three years studied, but well less than proportionately. Their results were similar for loans of consistent sizes in constant dollars over the three years, but their text focused on the 1964 data since the NCCF studied that year (page 5):

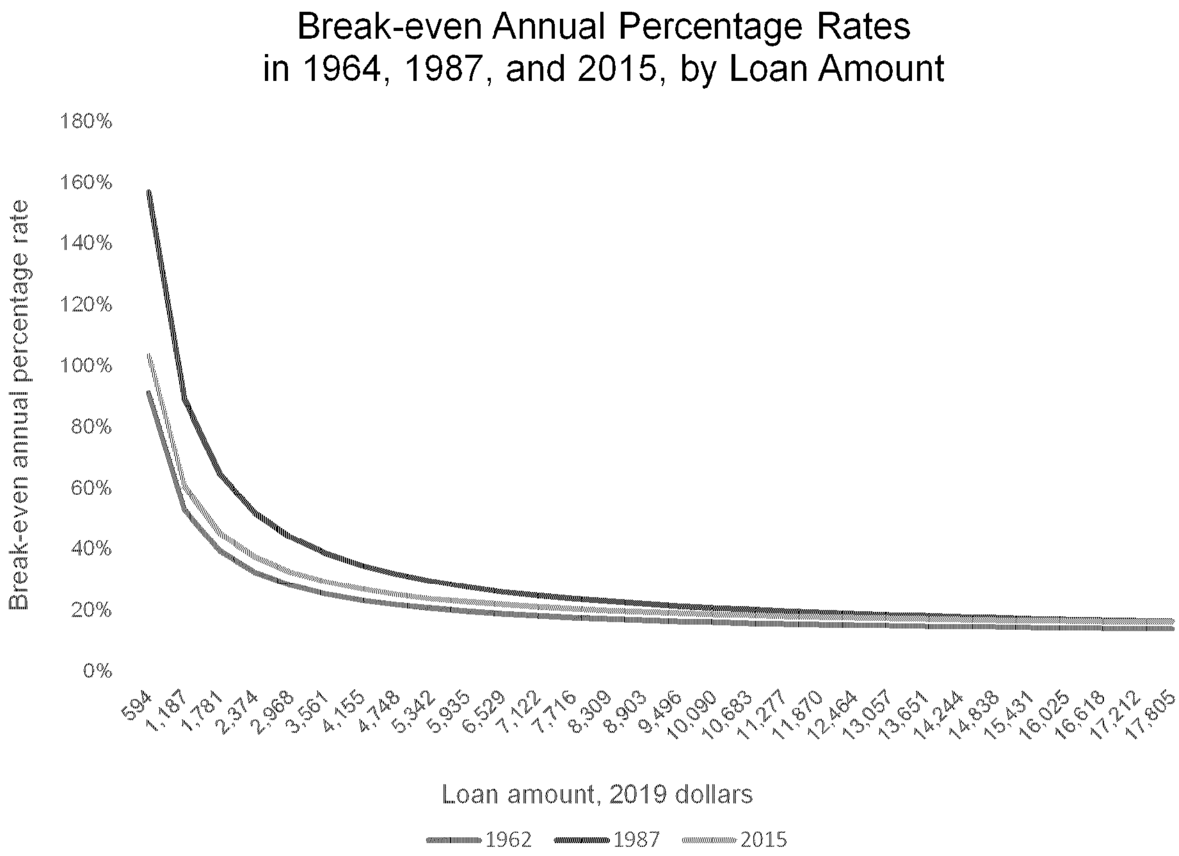
> The Commission estimated costs for loan amounts ranging from $100 to $3,000 ($594 to $17,805, in 2015 dollars). Estimated costs rose from $55.06 for a $100 loan to $231.80 for a $3,000 loan (Figure 1). As a percentage of the loan amount, however, costs declined. Costs declined from a little more than half the loan amount for a loan of $100 to 7.73 percent of the loan amount for a loan of $3,000 (Figure 1). As a percentage of loan amount, costs decline steeply at first and then more gradually as loan amount continues to rise. These findings are consistent with economies in regard to loan amount. *That is, loan costs increase less than proportionately with loan amount* [emphasis added].

With the cost results, it was then possible for Chen and Elliehausen to calculate APRs necessary to cover these costs at various loan sizes. They called these rates "break-even APRs" and calculated them for one-year installment loans for each of the three data years.[23] They displayed the results in their Chart 5, reproduced here as Figure 4-1. Again, results for the three years studied were very similar (see Figure 4-1).

[22] Lisa Chen, Gregory Elliehausen, and Mark Wicks (2018), *supra* note 21, Table 10.

[23] The NCCF specifically noted in its *Report* that APRs on loans made for a shorter interval would have to be higher due to being able to earn revenue for less time but that operating costs would still need to be recovered. According to the Commission (p. 145): "Recognizing that loans of [typical small sizes found then], the required APR will be higher than in Exhibit 7-16 [of the Commission's *Report*] because the costs of putting the loan on the books and servicing it must be recaptured over the shorter time."

FIGURE 4-1: BREAK-EVEN ANNUAL PERCENTAGE RATES IN 1964, 1987, AND 2015 BY LOAN AMOUNT



Sources: Data from Federal Reserve Board.

Table 4-2 contains a few examples for selected loan sizes developed by solving the equations underlying Figure 4-1 for the specific loan sizes. They show how the break-even APRs for loan amounts in constant dollars are remarkably similar in 2015 to those in 1964 and show the same pattern in 1987. (Figure 4-1 shows the complete range of possible loan sizes in graphical form.)

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TABLE 4-2: CALCULATED REQUIRED MINIMUM LOAN SIZE AT SELECTED APRS FOR TRADITIONAL INSTALLMENT CASH LENDERS, SELECTED YEARS (LOAN SIZES IN 2015 DOLLARS)

Selected APRs	1964	1987	2015
100	688	1187	620
60	1300	2259	1203
42	2072	3647	1994
36	2569	4550	2532

Source: Calculated from Lisa Chen and Gregory Elliehausen, "The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board's 2015 Survey of Finance Companies," *Feds Notes*, August, 2020.

Significantly, this table illustrates how installment cash lenders in 2015 would be unwilling to make loans at 36 percent APR smaller than about $2,500. At 60 percent APR, they would not want to make loans smaller than about $1,200 in 2015, and at 100 percent not smaller than about $600. In inflation-adjusted amounts, these loan sizes are very close to the NCCF estimates in 1972 of necessary loan sizes for year 1964 (see lower panel of Table 4-2). In 1987, when salaries, other operating costs, and funds costs were higher relative to lending amounts than in the other years, profitable lending required loan sizes that were larger but not dramatically different from the other years, and the pattern is similar.

And so, the contentions of the NCCF about installment lending are borne out by the newer statistical analysis: Rate ceilings on cash installment loans are not so much a limitation upon the revenues and profits of lenders as they are a determinant of the sizes of loans that lenders are willing to make. Borrowers of small amounts appear to be riskier than mainstream borrowers as shown by high operating costs and sizeable losses for lenders in this market. As shown by analysis of costs of these largely single-product credit sources over time, higher rates are necessary to make smaller loans available. The next chapter discusses these lenders further in the context of the kinds of lenders that operate in the small-dollar area.

Credit Cards and Other Consumer Lending Costs

The NCCF also considered costs of other institutions. Only limited further information about other institutions in the post-automation era is available, but these data at least provides an empirical feel for the differences in consumer-lending costs among classes of financial institutions.

For instance, for decades the Federal Reserve collected data on costs of different functions (like consumer lending) undertaken by commercial banks over the period 1957-98. The purpose of the program was to help individual banks understand and control their own costs by being able to compare them to the costs of other banks. Newer data are not available, but the old information shows that banks were lower-cost lenders both in terms of their operating costs and non-operating costs such as costs of loanable funds.[24]

By staying away from smaller consumer loans except through their credit-card programs, operating costs and losses per consumer-loan dollar were considerably lower for commercial banks than for consumer finance companies. Combining this advantage with their lower-cost "internal funding" enabled the banking industry to dominate the consumer lending market for larger loan sizes to less-risky borrowers, like new auto credit, for decades. (More recently, aggressive competitive response by manufacturers' auto-finance "captive" subsidiaries has enabled them to recapture sizeable market share in this area.) Except for credit cards, banks have not been successful in competing in the smaller-dollar lending area where they have encountered the same sorts of high operating costs per loan dollar and higher losses experienced by consumer finance companies.[25]

But credit-card programs are not like bank installment loans either, in that they must deal with ongoing advances of small amounts of credit worldwide and the capital-intensive and expensive systems these products entail. The credit advances also are unsecured, so costs and losses also arise on that basis. According to Federal Reserve figures, in the fourth quarter of 2019 (before the pandemic) bank losses on credit-card programs were 3.70 percent, about four times the loss rate on other bank consumer credit.[26]

Looking at the cost of card programs further, in the past Visa, Inc. periodically sponsored its own functional cost study to provide cost benchmarks to its members. The most recent survey available from 1994 also shows operating costs, including losses, per loan dollar to be above costs of other consumer lending by commercial banks although less than consumer finance companies.[27] Losses were the largest component of operating costs followed by wages and salaries. This is not especially surprising. Account size is smaller for card lenders than for typical bank closed-end consumer lending and larger than for the finance company small-dollar loans

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[24]See Evren Ors, Postmortem on the Federal Reserve's Functional Cost Program: How Useful Was the FCA? REVIEW OF FINANCIAL ECONOMICS, numbers 1-2 (2004).

[25]*See* Rae-Ann Miller, Susan Burhouse, Luke Reynolds, and Aileen G. Sampson, *A Template for Success: The FDIC's Small Dollar Loan Pilot Program*, FDIC QUARTERLY, number 2 (2010).

[26]Board of Governors of the Federal Reserve System, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, Statistical Release, August 24, 2020.

[27] *See* Visa, USA, *1995 Functional Cost Study* (San Mateo, CA: Visa Business Research and Reporting Department, 1995).

and there is ongoing need for expensive processing and communications for millions of small credit transactions and payments.

The Visa figures for 1994 show that operating costs accounted for 44.6 percent of total revenue, and funding costs only 31.1 percent. This means that APRs on credit card accounts will also be less based upon and less sensitive to funding costs than to operating costs per loan dollar.[28]

In 2006, the Governmental Accountability Office (GAO) found a similar relationship. Comparing credit card operations of a sample of large banks to "consumer lenders," by which discussion in the report shows they meant bank new-auto and personal loans, they found that credit-card operating costs were considerably higher than for "consumer lenders." According to the GAO report, "As a result, the average operating expense, as a percentage of total assets for banks that focus on credit card lending, averaged over 9 percent in 2005, as shown in Figure 31 [not reproduced here], which was well above the 3.44 percent average for other consumer lenders."[29] This again shows that operating expenses on credit card operations loom large relative to revenues on small balances. They are the reason why account APRs on credit card accounts, like those on other sorts of small dollar credit, are higher than on mainstream larger accounts and do not vary as much with funding costs.

Thus, it is worth noting again that the relative contribution of cost of funds to the final price of various loan products is also going to be reflected in the degree of responsiveness in their prices to changes in the underlying cost of funds. For instance, if cost of funds is a smaller proportion of total costs for credit-card programs than for other kinds of mainstream consumer lending, then card rates will not adjust as much to changes in the underlying cost of funds as other products, such as automobile loans and mortgages. This is the well-known credit card "stickiness" issue sometimes suggested in the past as a market failure when cost of funds declines.[30] This ignores how credit card interest rates also do not rise as much when underlying interest rates rise either. For example, during the period between 1982-9 when market interest

[28] Focusing on percentages of total costs rather than total revenues, Federal Reserve analysts around the same time found, not surprisingly, a similar relationship. Canner and Luckett calculated that operating costs of credit-card plans including servicing accounts, soliciting new accounts, and processing sales accounted for nearly 60 percent of total costs and the cost of funds only 27 percent with the remainder attributable to charge offs. *See* Glenn B. Canner and Charles A. Luckett, *Developments in the Pricing of Credit Card Services*, FEDERAL RESERVE BULLETIN, (September 1992).

[29] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURES TO CONSUMERS, 100 (2006).

[30] For discussion see Todd J. Zywicki, The Economics of Credit Cards, CHAPMAN LAW REVIEW 79, 111 (2000). See also Kathleen W. Johnson, Recent Developments in the Credit Card Market and the Financial Obligations Ratio, FEDERAL RESERVE BULLETIN, (Autumn 2005).

rates rose, card interest rates rose only slightly. By contrast, interest rates on mortgages and car loans rose proportionately more, tracking more closely changes in the underlying cost of funds.

And so from this cost information, even if less complete than preferable, a hierarchy in the cost structures of these consumer-lending institutions is visible. Banks' closed-end lending exhibits the lowest costs per loan dollar, followed upward by bank credit-card programs and then consumer finance-company cash installment loans. Given the smaller size and greater risk of consumer finance company loans and credit-card loans, it is not surprising that suppliers must charge more for these lending products if they are to stay in business or that rates of charge on these products are less sensitive to costs of funds than mortgage loans. Using a sample of data from 300 offices of two large payday lenders, FDIC researchers in 2005 showed that costs of payday lenders relative to loan amounts were the highest of any lenders studied, again reflecting the small size of the loans made.[32]The passage of time since these studies were undertaken suggests strongly to the Taskforce the usefulness for the CFPB of undertaking new and ongoing periodic studies of the costs of consumer lending.

In sum, production costs are crucial to the willingness of financial intermediaries to supply credit to individuals, as they are to the supply of any goods or services. For lenders, costs arise in the form of operating costs associated with origination, processing, collection, and losses. Non-operating costs include taxes, interest for acquiring loanable funds, and costs of capital. As indicated earlier, economic theory, as well as experience, suggests that intermediation lowers the overall cost of the transfer of resources from ultimate savers to borrowers, but it is still true that the prices charged for loans must cover operating and non-operating costs of the lending transfer process.

Further, the type of lending determines to a large degree the mix of operating and non-operating costs with operating costs looming larger per loan dollar on small amounts of credit due to the fixed nature of some of these costs. This means that for a given maturity, the rate of charge (APR) will also be higher on the smaller amounts of credit, borne out by empirical evidence.

4.4 Further Discussion of Lending Costs and Annual Percentage Rates

Considering costs and APRs further, it is not likely that consumers are very interested in operating and non-operating costs of consumer lenders. Evidence shows they are interested in the finance charges and Annual Percentage Rates necessary to cover these costs, however (see Chapter 7 below).

Finance charges and Annual Percentage Rates are required disclosures under Truth in Lending and both are measures of credit price, although they are not the same. They are determined jointly in the marketplace by the interaction of credit demand (arising from usefulness of credit) and its supply (dependent on production cost), as long as there is no external interference with the market (like controls).

Observers of Truth in Lending, including legislators and regulators but also anyone else interested in this area, should be careful to understand both of these price measures conceptually, because even though they are determined jointly under a single set of rules, they are not the same and do not have necessarily have the same uses. Using them wrongly could lead to a wrong decision.

The Truth in Lending "finance charge" is the cost of some specific amount of credit over some period of time expressed in dollars. In contrast, the APR is conceptually more like a "unit price" measurement of the price of the credit relative to credit amount over a specific unit of time, notably over a year.

It turns out, that both the finance charge and the APR can be more or less useful in decision making depending on the circumstances. As with a home chef contemplating a new and difficult recipe, a low unit price offered on a huge jar of some new and previously obscure ingredient may not represent the best bargain. The small jar of the right amount at a higher unit cost but lower dollar cost may be a better choice than the one at a lower unit price but costing more dollars. This, of course, does not argue in any way for not disclosing either the unit price or the dollar price.

Because they are determined jointly by demand and supply, there is no reason to assume that either of these price measures determined in a credit arrangement is in any sense "wrong," although almost everyone always wants prices of anything to be lower. The NCCF argued strongly and continuously in its Report in 1972 for ongoing government encouragement of competition in the granting of consumer credit, so that prices would be both "fair" and the lowest possible for given production costs. This Taskforce joins the NCCF in its insistence in the importance of competition, and. fortunately, it appears that consumer credit markets are more competitive today than in the NCCF's time (see Chapter 8 below). Truth in Lending undoubtedly should receive some of the thanks for this. But, as indicated, which measure of price is most useful in determining price that is "too high" relative to usefulness of the product can depend on the circumstances.

Experience shows that both the APR (unit price) and the finance charge are extremely important disclosures required by Truth in Lending, but also that neither is the most useful term to all consumers in all situations. Although experience indicates that most consumers will find APR useful for most decisions to at least some extent, different uses of the two price concepts should be understood for situations where the distinction is relevant. In particular, use of restrictions on unit prices (APRs) to implement a system of price controls on lending can interfere with the best dollar prices available for small preferred amounts of the product (credit). This could happen in the same way that restrictions on allowable unit prices of menu ingredients could frustrate chefs when it means that only larger jars that are more expensive in dollars jars are available.

In light of the previous discussion about how fixed costs cause differences in necessary prices for loans of different sizes, some further lending examples seem useful. Like with the chef's ingredients, it is possible for a loan with a lower unit price to have a higher dollar cost due to different sizes and maturities. The correct decision rule for the credit user in these situations (as for the chef) is not necessarily the lowest available unit price but rather the lowest available unit price for the needed amount and loan maturity. This produces the lowest available cost, the lowest available finance charge for the amount of credit and maturity in question.

Congress should receive its own credit for understanding the importance of both prices (finance charges) and unit prices (APRs) when it passed Truth in Lending in 1968 and required disclosure of both. Complaints arise from time to time that only one or the other is useful in certain situations, but any proposals for manipulating either concept that changes its usefulness or for encouraging sole focus on one or the other for normal kinds of consumer credit risks encouraging unwise credit decisions. The most useful approach is to recognize the situations in which the information conveyed by the two cost conceptions can be most useful and to be very careful what can happen when regulating by either. A few examples are in order.

Suppose that in some state there is demand for loans across a spectrum of loan sizes $500 and up. Suppose that this state permits rates approximating those indicated by the National Commission on Consumer Finance and Figure 4-1, for example APR of 95 percent on a $500 loan for six months and 72 percent for a $1000 loan for one year. Terms of these loans are as follows:

Small Loan

Amount	$500
APR	95 percent
Maturity	6 months
Payment size	$107.88
Finance charge	$147.31

Small Loan

Amount	$1000
APR	72 percent
Maturity	12 months
Payment size	$119.28
Finance charge	$431.32

Now, suppose for illustration that some other state limits the unit price (APR) to 27 percent. Based upon Figure 4-1, lenders would be unwilling to make these small cash installment loans in this state, due to insufficient revenue to cover costs. Suppose that lenders are willing to make loans at the lower rate if they are larger, however. To keep payment size down and to allow additional revenue to accrue, the loans also have longer maturities.

Suppose that lenders in this other state are willing to make loans of $2000 for two years at 27 percent APR. If this is the only sort of loan available to some borrower (because the borrower has no available credit-card credit), simple calculations show that monthly payments are about the same as on the $500 at 95 percent but the price (finance charge) is four times as high:

Larger Loan

Amount	$2000
APR	27 percent
Maturity	24 months
Payment size	$108.76
Finance charge	$610.25

The example shows that the borrower really needing only $500 and willing to repay over six months at 95 percent pays less than one quarter of the amount of the finance charge on the loan than the borrower at 27 percent ($147.31 versus $610.25). The difference arises because the loan available in the second state is both larger and longer. It clear that the second borrower is worse off, despite the much lower unit price (APR). The same is true for the borrower who needs a loan of $1000 for one year. In the first state the APR is 72 percent with accompanying finance charge of $431.32. In the second state the rate is lower at 27 percent but the loan is larger and longer resulting in a higher finance charge of $610.25. The borrower of the larger, longer loan at the lower rate could, of course, reduce the cost of the loan by fully paying it off early, but it is not clear how often this might occur. It also is not clear how many lower rate lenders would remain in the market if substantial proportions of their low-rate loans paid early.

Thus, this discussion assumes that the lender is willing to make the $2000 loan for two years. And, if either loan size or maturity becomes larger, the loan at the lower rate becomes even more expensive. For example, the next example below is for a $4000 loan with a 36 month maturity to make the payments affordable at this loan size. In this case, the finance charge is more than ten times the amount in the $500 loan for six months, despite the much lower APR (27 percent versus 95 percent). For a borrower in need of $500, borrowing $4000 to arrange credit availability is much more expensive than the $500 loan size needed size at an APR of 95 percent:

Larger Loan

Amount	$4000
APR	27 percent
Maturity	36 months
Payment size	$163.30
Finance charge	$1878.83

And so, the APR is a complete guide to the least expensive loan when the amount of the loan and its maturity are constant, but is only a partial guide otherwise. On small-dollar loans where size, rate, and maturity can all easily double or triple in size, more evaluation is necessary than just looking at the APR. As the examples here show, sometimes the highest APR can even produce the least-cost loan in dollars. In these situations regulating by the unit price eliminates the lower cost alternative in dollars. Not very surprisingly, users of small-dollar credit appear to find the dollar amount of the finance charge to be an important for understanding a loan's cost. There is more discussion of this research finding in the next chapter.

5. Small-dollar lending: the perennial problem

The modern American consumer economy has become a triumph in the modern world with the way it has facilitated higher quality of life for the majority of people. An important part of this triumph has been market-based credit for consumers who would not otherwise have ready access to the cash needed to change the timing of purchases in preferred ways and to minimize the effects of emergencies in ways that improve the quality of life. Beginning over a century ago, retail sources, manufacturers, and financial institutions began to provide mechanisms for consumers to change the scheduling of large purchases that provide a future return to a preferred purchase pattern. Although changing the time of purchase might sound mostly mundane, development of consumer and housing credit has enabled consumers to acquire homes, transportation, other durable goods, college educations, and needed services that provide a return over time at an earlier period in their life cycles than would otherwise have been possible. Acquiring them early is when they are most valuable, rather than saving and acquiring them only later, a process that can be slow and costly since it requires substitutes during the process.

The consumer-credit system has become intertwined with the growth of the American middle class and movement to the suburbs in the post-World War II era. Middle-class families today encounter a world of mainstream credit: bank loans, credit cards (largely replacing the retail installment sales and cash credit from retail stores and finance companies in earlier generations), automobile loans, student loans, and mortgage loans for housing. These mainstream credit products account for the overwhelming portion of credit for consumers in the United States today.

By contrast, many lower-income and other credit-constrained households encounter a different world. Although they often have access to mainstream credit products, that access can be more limited than for middle-class consumers. This fact sometimes leads them to supplemental credit suppliers at higher prices, as discussed by theorists/empiricists Juster and Shay and others. Yet they benefit from access to credit for the same reasons as middle-class consumers. They too use credit to purchase transportation to commute to jobs, for purchasing appliances like washing machines and refrigerators that provide a return over time, to manage the expensive challenges of children, and to mitigate emergency situations.

The challenge of small-dollar credit arises from the reality for many consumers, especially younger families, that their demand for credit often exceeds the available supply at mainstream prices. As discussed in Chapter 3, early in their financial life-cycle consumers have many very high-value investment opportunities, including consumer durable goods that provide a regular return over time. They also have emergencies that occur and that necessitate access to additional resources. But at the same time that consumer demand for credit is highest, credit supply is at its lowest state. For most people, one's starting salary is as low as it ever will be. Further, younger people typically own few assets (such as cars or real estate), have modest savings and financial investments (if any), a largely unproven credit record, and minimal experience with financial products. Even many middle-class college graduates owe substantial amounts on student loans upon graduation and are technically insolvent from the moment they reach the other side of the graduation stage.

In short, for millions of individuals, especially younger ones, their demand for additional credit is highest at the stage of their lives when their available supply of credit likely is lowest. As will be discussed, this means that many consumers are "rationed" in their credit access. As a result, many consumers are unable to meet all of their credit demand through mainstream financial providers, yet the demand remains. This dynamic is what gives rise to particular characteristics of the small-dollar loan market, which we explore in this chapter. The perennial problem of small-dollar credit has been enabling rationed consumers to gain access to needed credit at what is considered by observers to be a "reasonable" price instead of the price established through the free interplay of supply and demand. It is precisely this difficulty that has given rise to the recurrent experiences with interest-rate ceilings through history.

After reviewing millennia of history, centuries of economic theory, and decades of empirical analysis, the Taskforce concludes that the problem of providing small-dollar credit to wage-earners at what others consider to be "reasonable" prices is not only a perennial problem but is probably also unsolvable. Either small-dollar credit can be provided at market prices that take into account its production costs, it can be provided by massive governmental intervention at a cost that has never yet been politically acceptable (and which still would have to contend with operating costs), or it will not be provided at all. Legislative or regulatory mandates to set different prices cannot change those realities. So federal and state legislators are faced with a difficult choice.

5.1 The Economics of Small-Dollar Lending

Small-dollar lending is a distinct market with some submarkets for different kinds of small-dollar loans (specific kinds and estimated amounts are discussed later). But this does not mean that its economics is unique. As noted earlier, there have been constraints on lenders throughout history (Chapter 2 above), but there still is demand for credit based upon its usefulness (Chapter 3), and supply is still determined by its costs (Chapter 4). Attempts to subvert these realities at various times have continuously led to unintended consequences: unmet needs, evasions, and calls for new regulation in an unending cycle. The difference in small-dollar lending arises from its special constraints on both consumers (like liquidity challenges and poor credit history) and providers (costs and regulations), not from its fundamental economics.

The National Commission on Consumer Finance (NCCF) discussed in 1972 how all potential lending institutions face the restrictions on lending dictated by their cost structures, not just consumer finance companies whose costs are discussed at further length above in Chapter 4. Sometimes the view is heard that there was some time in the past that banks were better able to provide small-loan services than in more recent history when technological change has led them to providing smaller credit amounts only through their more restrictive credit-card programs. This is not the case. Writing before much of the growth in card programs that took place in the 1970s and 1980s, the Commission noted (p. 141):

> The costs of commercial banks reflect the grade of credit risks acceptable under their established finance rates, which are typically below their rate ceilings. Often by choice and sometimes because of low rate ceilings, commercial banks generally serve a less risky and, therefore, less costly segment of the market than finance companies. There is not, however, a clear delineation between the markets. Commercial banks must perform the same basic services as other credit grantors, and the costs of many of these services are fixed, regardless of the amount of credit extended.

The Commission then went on to discuss further the cost structure of personal lending by commercial banks at the time using data available then. The Commission found banks' cost curves by loan size similar to those of consumer finance companies.

The idea that banks were not servicing the needs of small loan borrowers was not new with the Commission. For instance, writing about the experiences of railroad clerk John Doherty in 1910 as an example of conditions then, Anne Fleming noted, "For borrowers like John Doherty, in need of cash rather than credit to buy goods, there were a number of sources available. Banks were not among them, however. Commercial banks did not make small loans, particularly to low-income working-class borrowers." Writing about 1937, she added, "Personal finance companies and banks did not serve the same clientele, however. In the 1930s and 40s, bank borrowers usually had higher incomes than clients of personal finance companies, who were drawn from the 'lower middle income and lower income groups."[1]

The Fundamentals

In their economic analysis of credit-use decisions in 1964 (discussed here in Chapter 3 as part of the development of the economics of consumer credit), Juster and Shay explained the theoretical reasons why consumers are sometimes willing to borrow at high rates of interest. To summarize, rates of return for benefits of purchases made on credit can be quite high and under the circumstances households would be willing to borrow to make these purchases or mitigate emergencies.

But because income and accumulated savings of borrowers are often limited, primary lenders (low-rate lenders) limit the amount of credit they are willing to offer them. This means benefits from some additional consumer expenditure might exceed the borrowing cost from primary lenders but primary lenders are unwilling to lend more. Low-rate lenders may be unwilling to lend at all to some potential borrowers desiring credit. This is known as credit rationing and it is discussed further next. A continuum of specialized secondary lenders willing to lend small amounts might arise and relax the credit constraint and in many situations provide solutions to needs and problems, increasing overall consumer utility. But lending small amounts is costly due to operating costs and higher risks.

Chapter 4 examined credit supply and showed where lending costs come from: Credit involves a production process called financial intermediation that provides services but also entails costs. There are production costs consisting of origination, processing, bad-debt, and capital costs. These production costs include more than simple forbearance cost that arises from giving up alternative uses of the funds by the lender (historically called "interest"). Production costs were understood even in medieval times when rate ceilings were part of religious law that prevailed in most of Europe then. The framers of the Truth in Lending Act understood this too, and they defined the cost of credit as the "finance charge" and not "interest."

Chapter 4 also looked at the economic reasons why supplying a small-dollar loan is more costly per loan dollar than supplying a mainstream loan: many *operating* costs of lending are fixed

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[1] ANNE FLEMING, CITY OF DEBTORS (2018), p. 21 and p. 97, respectively.

costs or close to fixed. Fixed operating costs then loom larger and larger per loan dollar as the loan size becomes smaller and smaller.

In contrast and unlike operating costs, costs of loanable funds increase proportionally as loan size increases. For example, interest paid on the second million or billion dollars of loanable funds for a lender to use to make new-auto loans is going to be much the same as the interest paid on the first million or billion dollars of loanable funds. In other words, cost of obtaining the loanable funds is going to be much the same for each lendable dollar in a particular capital market, up to the limit of the lender to obtain those funds. This means that as loan size becomes smaller, total *funding costs* loom smaller compared to fixed operating costs on a smaller and smaller consumer loan until most of the loan cost on a tiny loan is due to operating cost. Conversely, total funding costs loom larger compared to operating costs as loans become larger, until most of the cost of the loan is funding cost on a very large loan.

Not surprisingly, these relationships produce a hierarchy of economic lending costs per loan dollar for consumer lending. Costs of making small loans are going to approximate the operating costs. Since, as shown in Chapter 4, the operating costs on a small loan are high per loan dollar, so is the total cost of the loan per loan dollar. In contrast, for large loans the operating costs per loan dollar almost disappear compared to the funding costs, and the funding costs dominate. For the small loans, operating costs dominate.

But even so, other things are still not equal: It is also reasonable to expect, and empirical information demonstrates, that small loans are also typically riskier for lenders than larger loans due to the circumstances of borrowers who need small loans. This adds to operating costs of lending smaller amounts. As discussed at greater length in Chapter 4, additional costs of managing risk and the possibility of losses can make producing small loans even absolutely more expensive than larger loans, and not just relatively per loan dollar. So, if small loans are more costly to make per loan per loan dollar than larger loans, finance charges per loan dollar and accompanying APRs will also have to be higher on small loans to cover costs and make lenders willing to lend.

Even though these ideas have been basically understood since at least the middle ages, this does not make them satisfactory, or even acceptable, to many observers. Consequently, attempts to change and subvert the basic economics of lending through price ceilings have existed throughout history. These attempts have enhanced the reality of credit rationing, the situation where credit supply falls short of demand at the market price.

The Realities of Credit Rationing

In modern terms, those frozen out by the system become "rationed borrowers" in Juster and Shay's terminology.[2] If rate ceilings are set relatively low, all borrowers become restricted to "primary lenders" that make loans at low rates, which typically excludes small loans. If ceilings are somewhat higher, there can also be "secondary lenders" in the marketplace that expand the availability of legal credit. Even if there were no ceilings, however, lenders will limit the amount of credit of both kinds at some point. The economic theory of credit rationing predicts that lenders will restrict credit when risk and other costs exceed profit potential, and experience shows this is what happens.

Modern economic theory of credit rationing based upon statistical conceptions of risk has become another highly technical and mathematical area of economic theory, but, as indicated, the underlying economic concepts are clear enough and have been understood and discussed for centuries.

Credit is like other goods and services in that revenues must cover operating and nonoperating costs or suppliers will not provide it. It is not like other goods and services, however, in that, as indicated, its providers are also subject to one more cost aspect that arises from its intertemporal nature: how the repayments are expected after or over a period of time. This aspect of lending generates uncertainty and risk about whether the future promised payments actually will be received, and this risk of nonpayment is potentially costly. Much of the art and science of consumer lending goes into managing this nonpayment (default) risk.

Modern economic theory of credit rationing shows that even in a lending market completely unconstrained by price ceilings lenders will not lend unlimited amounts, since as they lend default risk rises. At the time of development of modern economic theory in this area that included also the work of many others, Juster and Shay pointed out that at some point primary (low-rate) lenders would be unwilling to lend more, even if borrowers were willing to borrow more at the same rates. In these cases, individuals seeking more credit would need to turn to secondary (higher-rate) lenders.

Due to default risk, at some point even the secondary lenders would be unwilling to lend more. In both cases, default risk produces a situation where there might not be normal supply-demand

[2]*See F.* THOMAS JUSTER and ROBERT P. SHAY, CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION (1964).

equilibrium through a market-clearing price because under conditions of increasing default risk lenders are unwilling to supply more credit. Although specifics of the complete theory are considerably more complicated than discussed here, the result is credit rationing.[3]

Juster and Shay's theoretical analysis produced two types of outcomes, an equilibrium outcome and a rationing outcome. They considered first a simple example in which there are two borrowing rates, a lower rate charged by primary lenders and a higher rate charged by supplemental lenders. Both sorts of lenders have an absolute limit on the amount that can be borrowed. The consumer undertakes household-related investments until the rate of return on investment equals the borrowing rate charged by primary lenders. In this case, the amount borrowed does not exceed the limit set by primary lenders.

Rationing outcomes occur when the consumer is unable to equate the rate of return and the borrowing rate because lenders are not willing to lend more even if the rate is acceptable to potential customers. There are two rationing situations. The first occurs when the consumer is willing to take on the debt at the rate available from primary lenders, but the absolute limit on the amount of credit available from primary lenders prevents a consumer from borrowing further at their lower rate (rationing). In this case, the return on investment for the borrower is not sufficiently high to justify borrowing at the next higher available rate and borrowing stops.

A second rationing outcome occurs when the consumer exhausts availability of credit at the lower rate charged by primary lenders and borrows at the higher rate of the next of a tier of secondary lenders. The borrower's rate of return and rate of time preference may be equal to the higher rate charged by supplemental lenders, but no loan will be forthcoming if the amount of borrowing exceeds the supplemental lenders' limit at this higher rate. Again, rationing takes place and can prevent the individual from taking advantage of an available opportunity (or satisfy a necessity or emergency).

These theoretical contentions are consistent with empirical evidence. It is well known that many good credit risks do not borrow the full amounts that primary (low-rate) lenders are willing to lend them (that is, their expected rate of return on additional credit use is less than the

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3 For the classic modern discussion of credit rationing, see Dwight M. Jaffee and Franco Modigliani, A Theory and Test of Credit Rationing, AMERICAN ECONOMIC REVIEW, (December 1969), and Dwight M. Jaffee and Thomas Russell, Imperfect Information, Uncertainty, and Credit Rationing, QUARTERLY JOURNAL OF ECONOMICS, (November 1976). Precise discussion of the neoclassical economics of credit rationing requires graphical and/or mathematical presentation using calculus. See THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI CONSUMER CREDIT AND THE AMERICAN ECONOMY (2014), which provides discussion and graphs of these and other technical analyses of credit rationing in their Chapter 5 and its mathematical appendix.

borrowing rate for them). This is not rationing but is choice based upon supply and demand. It is equally well known that lower-rate lenders limit borrowing at their normal rates of charge, however, even if borrowers are sometimes willing to borrow more at these rates. It is also well known that even secondary lenders are unwilling to lend unlimited amounts.

Although the complete theory of credit rationing allows for its existence even in the absence of some sort of external limitation on price, price limits established by governments have been the most common cause of credit rationing historically. As with any product, producers of consumer credit must cover their costs if they are to remain in business. For lending, expected default costs are part of the cost structure that lenders must consider and cover. As outlined briefly above in Chapter 2 above and at somewhat greater length by the NCCF in its Chapter 6, price ceilings established by government action have constrained lenders attempting to cover costs since ancient times.[4]

Theoretical development suggests that borrowers potentially rationed will tend to have relatively low or moderate current incomes and little discretionary income. Without credit, they would have to make large sacrifices in current consumption to pay for large or unexpected current expenses, making the purchases personally very costly. Because of moderate incomes and often younger age, these rationed borrowers generally would not have accumulated large amounts of liquid assets. At this stage in their life cycle, any liquid asset holdings for these individuals would have a high subjective yield anyway, because of precautionary needs, and they might well prefer not to use them.[5]

Available evidence shows that this theoretical profile does indeed describe users of small-dollar consumer credit. Surveys of small-dollar borrowers show that they are younger, lower-income, and more credit-constrained than non-users of these kinds of credit (Table 5-1). This means they will disproportionately include individuals with higher potential demand for credit use (greater returns) and lower potential credit supply. They are users of mainstream consumer credit when possible, but typically they have fewer sources when needed and more difficulty in obtaining mainstream credit.

[4] *See also* SIDNEY HOMER AND RICHARD SYLLA, A HISTORY OF INTEREST RATES, 3RD ED. (1996).

[5] For discussion of importance of precautionary reserves to individuals, see GEORGE KATONA, PSYCHOLOGICAL ECONOMICS (1975), especially chapter 16.

TABLE 5-1: DEMOGRAPHIC INFORMATION ON SMALL-DOLLAR BORROWERS IN 2015

	Pawn loan	Vehicle title	Payday loan	Non users
Approximate Annual Household Income ($thousands)				
Less than $15	21	9	13	10
15-24	19	11	14	10
25-34	16	14	15	10
35-49	16	15	16	14
50-74	16	23	21	21
$75 or more	12	29	22	36
Total	100	100	100	100
Age				
18-24 years old	14	15	14	9
25-35	26	33	31	15
35-44	22	22	23	15
45-54	20	15	16	19
55-64	13	9	11	19
65 or older	5	6	6	22
Total	100	100	100	100
Life Cycle Stage				
<45, Married, has children	33	45	40	22
<45, Married, no children	1	1	1	1
<45, Not married, no children	3	3	3	2
>45, Married, has children	10	11	9	17
>45, Married, no children	8	10	8	33

>45, Not married, no children	14	8	11	15
Any age, not married, has children	31	22	29	11
Total	100	100	100	100

Note: Recent demographic information on borrowers at traditional cash installment lenders is not available.

Source of Table: Data from the 2015 National Financial Capability Study, Financial Industry Regulatory Authority (FINRA) with the US Department of the Treasury and the President's Advisory Council on Financial Capability, as calculated and reported by J. Brandon Bolen, Gregory Elliehausen, and Thomas W. Miller, Jr., "Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research," *Economic Inquiry*, April, 2020, Table 2.

Columns many not add to totals because of rounding.

Consistent with Juster and Shay's theory of rationed consumers, the important characteristic of consumers who use alternative financial products is that they are constrained in their access to mainstream credit. For example, the overwhelming number of payday loan customers do not have access to credit cards or would exceed their credit limits if they tried to use them,[6] were recently denied access to credit,[7] or searched intensely for credit before accessing their first payday loan.[8] For auto title pawn loans, only about 20 percent of auto title loan customers had credit cards.[9] With respect to overdraft protection, one survey of frequent users of overdraft protection found that only 7 percent of respondents reported that they had "good" credit, compared to 32 percent who said they had "poor" credit.[10] Also, most studies of small-dollar lending find that consumers report that they use small-dollar lending products mostly to meet

[6]Elliehausen found that only about half of payday loan customer had credit cards, 67% either had no credit card or would have exceeded their credit limit if they used the card, and 90% had either no cards or less than $300 in available credit card lines of credit). See Gregory Elliehausen, *An Analysis of Consumers' Use of Payday Loans*, GEORGETOWN UNIVERSITY CREDIT RESEARCH CENTER MONOGRAPH, No. 41 (2009).

[7]*See* ELLIEHAUSEN (2009), *supra* note 6, *also see* AMANDA LOGAN AND CHRISTIAN E. WELLER, WHO BORROWS FROM PAYDAY LENDERS? AN ANALYSIS OF NEWLY AVAILABLE DATA (2009).

[8]See Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, *Payday Loan Choices and Consequences*, JOURNAL OF MONEY, CREDIT, AND BANKING, (March, 2015).

[9]See Jim Hawkins, Credit on Wheels: The Law and Business of Auto-Title Lending, WASHINGTON AND LEE LAW REVIEW (2012).

[10]See Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, WASHINGTON AND LEE LAW REVIEW (2012).

urgent and important financial obligations, such as rent, utilities, car repairs, and household necessities such as food, clothing, medicine, and gasoline.[11]

These survey findings are consistent with neoclassical economics that the major motivation for credit use involves situations where there is a positive return over time but rationing may affect some potential borrowers, in this case sending them to secondary lenders. There are, of course, also significant and well-known risks of unfortunate outcomes associated with any credit use, and these forms of supplementary credit are certainly not an exception.

Short term credit products can also facilitate the accumulation of household assets for credit-constrained individuals even when they are not used directly to finance the actual household investment: Availability of short term credit when needed can reduce consumers' vulnerability to unexpected expenses or short-term fluctuations in income when they already have debts involving the financing of household investment. Although these short term credit products may be very costly per loan dollar, consumer losses resulting from illiquidity may be quite large as well. Even simple late payments of utility bills due to illiquidity, for example, can cause a consumer to incur late-payment fees, loss of deposits on monthly utility bills, and reconnect fees.

Those facing such circumstances typically are at the life-cycle stage where needs and returns can be high but resources often are limited. They then become potential small-dollar borrowers from secondary lenders. It also appears that many of them age out of this kind of credit as they establish themselves financially and graduate into greater access to mainstream credit, although some do not. Further, there is a pattern whereby some products are less desirable than others based on cost and features. Thus, if credit rationing by primary lenders affects access of individuals to preferred forms of credit (including more convenient forms like credit-card credit), they can still move down the order of preference to less desirable (and typically more expensive) kinds of credit. These various sorts of small-dollar products are discussed further below.

[11] *See* ELLIEHAUSEN (2009), *supra* note 6. *See also* Hawkins (2012), *supra* note 9, and G. Michael Flores and Todd J. Zywicki, *Commentary: CFPB Study of Overdraft Programs,* MERCATUS CENTER, GEORGE MASON UNIVERSITY (2013).

5.2 Small Amounts of Credit in Recent History

Amounts of small-dollar credit in use today amount to only a small fraction of the approximately $4 trillion of consumer credit in use, but the numbers are certainly consequential. The Federal Reserve does not provide estimates of amounts specifically of small-dollar consumer credit within its aggregate amounts, but others have attempted this, using various sources of data.

One summary in an academic study published in 2020 provides some estimates of small-dollar credit use in 2016 and 2017 (Table 5-2).[12] Estimated totals for cash installment loans, pawn loans, vehicle title loans and payday loans were about $75 billion in these recent years, much less than other common forms of mainstream consumer lending. Amounts naturally are going to be smaller for "small-dollar" lending, but evidence also suggests that only a small fraction of the public uses these loans. According to the 2017 FDIC Unbanked-Underbanked Supplement to the Current Population Survey, 1.7 percent of households used payday loans, 1.4 percent used pawn loans, and 1.4 percent used automobile title loans. (This source does not report on traditional installment cash loans from finance companies.)

TABLE 5-2: ESTIMATED DOLLARS BORROWED IN SMALL-DOLLAR LOANS 2016 AND 2017

	2016	2017
Dollars Borrowed (Billions)		
Installment cash loans	18	20
Pawn transactions	14	14
Vehicle title loans	6	7
Payday loans (storefront)	20	18
Payday loans (online)	15	15
Total Small Dollar	74	73
For Comparison		

[12] See J. Brandon Bolen, Gregory Ellihausen, and Thomas W. Miller, Jr., Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research, ECONOMIC INQUIRY, Table 1 (April 2020).

Credit card lending	415	406
Automobile lending	591	595
Student loans	130	135

Source: Center for Financial Services Innovation (CFSI), December 2017 as reported by J. Brandon Bolen, Gregory Elliehausen, and Thomas W. Miller, Jr., "Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research," *Economic Inquiry*, April, 2020, Table 1. CFSI cites data from "Alternative Financial Services: Innovating to Meet Customer Needs in an Evolving Regulatory Framework" by John Hecht, Stephens, Inc. 2014, and statements by John Hecht for Jefferies, Inc., 2015–2016. In addition, for pawn, payday, and installment loans, CFSI estimates are based on publicly traded industry leaders' annual and quarterly report data (2009–2017), market share data, and figures reported by the National Pawn Brokers Association. For payday, rollovers are counted as discrete volume. For Title lending CFSI estimates are based on state-specific title loan incidence, volume, and revenue data reported by regulatory agencies in CA, IL, NM, TN, TX, and VA (2009–2016 as available); 2016 Revenue Data from the Center for Responsible Lending "Payday and Car Title Lenders Drain $8 Billion in fees Every Year," (2017), footprint of auto title lending locations and proportion of states offering installment and single-payment models for all states where the practice is legal sourced from "Driven to Disaster: Car Title Lending and Its Impact on Consumers," Center for Responsible Lending (2013); additional data on proportional use of installment and single-payment auto title sourced from "Payday and Auto Title Lending in Texas, Market Overview and Trends 2012–2015," Texas Appleseed (2016). Rollovers counted as discrete volume. Data for credit card debt, automobile debt, and student loan debt is available from the Consumer Financial Protection Bureau at https://www.consumerfinance.gov/data-research/consumer-credit-trends/.

Historical Review by the National Commission on Consumer Finance

In 1972, the National Commission on Consumer Finance devoted a considerable portion of its attention to policy issues surrounding small-dollar consumer credit. Beyond merely pointing them out and referring to past reform efforts in the small-dollar lending area, the NCCF undertook and sponsored new empirical studies and encouraged more. Significantly, the NCCF argued for removing barriers to competition in financial markets in order to guarantee that charges for credit would be as low as possible in all areas of credit granting, including this one and its variations. Over the intervening years, regulators and institutions have implemented favorable competitive changes, but controversy over lending costs and necessary revenues for small-dollar loans remains.

The NCCF began its discussion of interest rates with its Chapter 6 titled "Rate Ceilings." The Commission described the two competing approaches over the millennia as "Free Rates" and "Decreed Rates." Both date to antiquity almost four thousand years ago. The Commission pointed out that interest-rate history shows that rates have always fluctuated with supply and demand, and so there is always going to be potential for conflict over interest rates between economic conditions and laws governing permissible rates.

Interest-rate history is also a history of violations of laws decreeing rates and subterfuges around various prohibitions. There were laws regulating loans and lenders in the ancient Babylon of Hammurabi, with penalties for violations (records are in the British Museum to this day). Lenders in the Roman Forum were faced by interest-rate limitations (often ignored) as were potential medieval lenders. The NCCF pointed out how charitable lending institutions for the poor in the form of public pawn shops existed specifically as a way around rate limitations for small loans by at least the fifteenth century. Apparently, small money-emergencies arose even before there was much of a money economy. Interest-rate ceilings continued to exist in the western European countries that sent colonists to North America in the seventeenth century, and settlers from England brought the experience of ceilings with them to the colonies and the early United States.

England repealed its rate ceilings in the 1850s, but during the NCCF's time all states except New Hampshire and Massachusetts still had general rate ceilings (still known as "usury laws" using the Biblical and medieval term). As outlined above in Chapter 2, by the early twentieth century, most states had also created various exceptions to their usury laws for various kinds of consumer credit but without eliminating the concept of ceilings. These exceptions consisted of special rate provisions according to institutional class and credit type: for small consumer cash loans at finance companies with state licenses (licensed lenders or small loan companies); for various kinds of loans (with or without deposits) at banks, credit unions, and industrial banking companies ("Morris Plan" banks); and at other regulated small-dollar lenders like pawn shops.

In the early twentieth century states also began to control "time-price differentials" on purchase of goods and services using credit from retail outlets and dealers that were another way around usury laws. Most states created the various clarifications and exceptions to their usury laws to facilitate the flow of consumer credit. The NCCF noted the extent and variety of these arrangements with examples and called the result a "hodgepodge." The Commission was quite evidently concerned whether the range of exceptions to legal requirements at the time was sufficiently broad to permit generation of needed credit availability under the competitive conditions it saw as desirable. It clearly was concerned that the "hodgepodge" had created gaps and limited markets into pockets where competition would be insufficient to generate the lowest possible prices consistent with production costs for all amounts of credit.[13]

The Commission concluded its own historical review, seemingly indicating its frustration, by quoting from Sidney Homer's *History of Interest Rates* about how the controversy never seems to end (NCCF *Report*, p. 93):

> The controversy did not end with the Reformation and the modification of Church doctrine. It continued and continues. It is now couched largely in terms of justice and expediency, laissez faire or economic controls, controlled rates (supposed to be low) versus free rates (supposed to be higher). ... The rate of interest in the twentieth-century is often limited by law. It is still a subject of controversy, not only among economists, but equally among politicians and economic groups. Some like it high; some like it low.

The Commission then turned to discussion of purposes of rate ceilings on consumer credit commonly given. The Commission found four and discussed each at some length. In this discussion, the Commission contended that varieties of reasons were still advanced domestically, despite absence of governmental ceilings in most other countries it examined. Debate over the wisdom of price controls continued into the 1970s during the high-interest rates of those years that rendered usury ceilings even more disruptive than was usually the case in the past. These concerns seem generally less important today than in the NCCF's time as rates have subsided generally, although disputes in the small-dollar area have continued.

The examination of usury ceilings was important to the Commission on account of its legislative charge to study and appraise "the adequacy of existing arrangements to provide consumer credit at reasonable rates" (Consumer Credit Protection Act 404(a)(1)). The Commission concluded that credit rationing arose from rate ceilings and also from insufficient competition in some parts of consumer credit markets caused by the inefficient system of interest-rate ceilings and various exceptions only for specific institutions.

The first possible purpose of ceilings discussed by the Commission was "to redress unequal bargaining power" (NCCF *Report*, p. 96). This was the idea that rates always rose to the ceiling

[13] Chapter 2 of this Taskforce report discusses a bit more about how rate ceilings and restrictions on other credit terms at this time differed by institutional class of the lender and often prevented lenders in one class from offering a set of terms offered by another class of lenders. The NCCF and others in its time also commented on how the variety of rate ceilings and loan size limitations in force could produce gaps in credit availability at different loan sizes and even situations where high-cost providers might be permitted to make loans of certain sizes while low-cost providers might be prevented from doing so. There is further interesting discussion of these possibilities with a graph that shows how they can happen in DAVID H. ROGERS, CONSUMER BANKING IN NEW YORK, 117-21 (1974).

and so ceilings were necessary to keep them from rising too far. The Commission showed that rates did not always rise to ceilings through its review of empirical evidence previously available and through extensive new rate surveys it undertook. Instead, the Commission found that rates generally did not rise to ceilings in mainstream consumer-credit markets "except when the price ceiling is set at or below the market rate for the particular form of credit placed under price control" (*Report*, p. 96). The latter area involved cash installment loans that were subject to relatively low rate ceilings relative to their production costs. These were the most important source of small-dollar loans at the time.

There generally does not appear to be much request today for ceilings in other areas. Such other areas include mainstream mortgage lending, automobile, home improvement, and credit-card credit. Institutions establish rates based upon market conditions and competition in these areas. Rates on much of credit-card credit today also fluctuate with changes in an underlying market-rate index outside the institution's control. The Commission believed that Truth in Lending would continue to improve competitive conditions in these areas, which it appears to have done.

The Commission indicated a second reason sometimes given for favoring ceilings as "to avoid overburdening consumers with excessive debts" (*Report*, p. 99). The Commission contended that "the theory is sustainable if it can be shown that consumers who would pay rates above ceilings are those who would become overindebted" (*Report*, p. 99). Even then the Commission did not recommend the ceiling approach. Rather, ultimately it contended that it is the demand and supply for credit that determines the volume of debts, including the possibility of credit rationing by the suppliers.

The Commission maintained that it is not rate ceilings in some part of the market that accomplishes the task of limiting debts. Instead, excessive indebtedness springs from lending mistakes. To be sure, events subsequent to a loan can produce unfortunate outcomes to credit situations entered responsibly by both borrowers and lenders (that is, these intertemporal transactions are subject to risk of subsequent events). Sometimes other lending mistakes were made, but neither risk nor lending mistakes means that rate ceilings were necessary to prevent general overextensions of credit. The Commission contended that rate ceilings would instead merely produce a lowering of risk acceptance overall, with lowering of credit availability to riskier potential customers possibly in need of additional credit.

The Commission also cited a third reason sometimes advanced for ceilings, "to administer credit grantors as public utilities" (*Report*, p. 102). Not much is heard about this idea today, but it certainly is not dead. The Commission continued: "This approach recognizes that if consumers are to be served, rate ceilings must be high enough to permit credit grantors to earn an adequate rate of return on their invested capital" (p. 102). In other words, this approach would allow lenders to be able to operate on a "cost plus" basis. The Commission noted that this requires knowledge of production costs to generate cost-plus legal pricing, but that its real impact would be segmentation by risk class chosen making this approach "a self-fulling result of the risk class served" (p. 102).

The Commission pointed out that this approach would require "a rate commission that would have to specify in some manner the highest risk class of consumers that could and *should* (emphasis in original) be served by each credit grantor" (p. 102):

> Unless the rate commission were then prepared to examine the validity of credit turndowns for each franchisee, credit grantors operating under a fixed rate ceiling could improve their profit margin by denying credit to riskier consumers and by not offering costly forms of credit, such as small short-term loans. The establishment of credit standards; and appropriate prices for multifaceted credit arrangements and the enforcement of requirements that credit grantors meet any "justified" demands by consumers of widely varying credit standings pose dire problems for a ratemaking-commission governing franchised consumer credit grantors.

It seems that this concern would still exist if this approach were advanced today, but the NCCF also discussed some further "practical difficulties." One was cost measurement for multiproduct financial institutions like banks and proper allocation of joint costs. Another was the existence of extensive availability of retail-store and dealer credit at the time where charges for credit could easily be buried in the cost of goods. A further one was the highly mobile nature of lending assets. Mispricing by public rate authorities would not immediately eliminate the availability of electrical service while the electric utility company struggled for profitability. The nature of the fixed assets in electricity generation (generating plants and distribution infrastructure) could not easily be employed in different uses. This would not be true of highly-mobile lending assets that would quickly move to other uses.

The NCCF also discussed a fourth argument sometimes advanced as favoring rate ceilings and the "most compelling problem to be considered," namely "to assure that consumers pay fair rates for credit" (p. 103). Following its analysis, the Commission again concluded that this issue amounted to another label for the same problem: fair for whom? Again, the outcome (and societal value judgement) would depend on which *risk classes* of consumers the system would allow to obtain legal credit. Higher risk classes would simply be more costly to serve, and this was the crux of the problem. Charging them higher prices than others was offensive to some, but rate ceilings would preclude their obtaining credit. How to manage this dilemma becomes a societal problem.

The Commission recommended that governments reconsider the need for interest-rate ceilings and take available steps to improve competition in consumer credit markets generally. As also indicated in Chapter 2 above, many states made changes to their interest-rate regimes during and following the extremely high interest rate period surrounding the year 1980, and consumer-credit granting institutions are generally much more competitive today. These changes and the broad decline of interest rates since the early 1980s have tended to make interest-rate ceilings much less contentious in recent decades, except in the case of small-dollar credit.

On balance, the Commission appeared to favor permitting existence of smaller-dollar credit from commercial sources, as long as regulatory conditions provided a competitive marketplace (p. 149):

> The Commission recommends that each state evaluate the competitiveness of its markets before considering raising or lowering rate ceilings from present levels. Policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed.

Evidence shows that even this hedged recommendation was controversial at the time, even within the Commission itself (see the exchange between commissioners Senator William Proxmire (pp. 220-30 and 263-4) and Professor Robert W. Johnson (pp. 243-62)). As indicated already in this Taskforce report, allowable rates on small amounts of credit remain controversial today, in at least the fourth millennium of this debate.

Recent Developments

The NCCF discussed at some length the main kinds of small-dollar lenders in existence then, notably traditional cash installment lenders (then known as licensed lenders or small loan companies) and retail outlets. There also were pawn lenders that the Commission did not discuss. These credit sources still exist, but today there also are other small-dollar lenders, including whole new industries such as payday and automobile-title lenders. There is also a related depository-institution product referred to as overdraft protection or sometimes as "bounce protection." Further, there also are rent-to-own outlets. Taken together, these lenders have arisen on account of credit rationing by low-rate lenders and they cater to a range of risks. All of them must contend with the fixed costs of lending that loom large per loan dollar on small amounts of risky credit extensions.

It seems that much of the criticism of small-dollar lending and lenders from ancient times to the delivery of the NCCF's Report and beyond reflects the view that charges for credit use reflect in large part the attempt by lenders to take advantage of borrowers. In economic terms a situation of this sort would be called a "market failure" in that markets are not providing for the needs (demand) in the marketplace at the minimum price that covers costs and allows for exchange. In effect, some observers through history from the Bible through ancient credit codes and up to the NCCF and the present time have suggested that much of high-rate lending results from the present-bias of borrowers that allows for price gouging by unscrupulous lenders.

As discussed here in Chapters 3, 4, and this chapter, economic theory and empirical evidence have shown there is more to the story. Most credit use by individuals today arises from opportunities that provide benefits over time including a preferred consumption time pattern. Economic theory also suggests that small-dollar lending will arise in situations where willing borrowers are constrained by credit rationing of low-cost lenders to limit risk. Higher-rate lenders will emerge, but if small amounts of credit to risky borrowers are involved, production costs per loan dollar are high. This means that prices at which market exchanges (lending) takes place will also be high.

Available empirical evidence is consistent with this theory, but some observers apparently still maintain the market-failure contention. For instance, in its 2017 rulemaking concerning "payday" lending, the Consumer Financial Protection Bureau argued that the desperate condition of payday borrowers indicated they would pay almost any price and that biases toward considering only the present prevented them from fully understanding the costs of payday loans, views supported by many commentators.

Existence of large numbers of small-dollar credit sources where allowed, however, does not suggest existence of a comprehensive market failure like monopoly power conditions that allow price gouging. Lending does not require large fixed investments such as electric power generating stations that permit scale economies and discourage market entry by others. There also are no patents or secret processes in lending. Barriers to entry are low, except in states that create regulatory barriers to entry. Available empirical evidence indicates that although the price charged for small-dollar loans is high in APR terms, those prices appear to be the result of high operating costs including high loss rates per loan dollar on small-dollar lending (see Chapter 4). As discussed further below in Chapter 8, there is no evidence of supranormal profits or rates of return for businesses operating in the small-dollar loan market[14]. Rather, it seems that where

[14]Lack of public data has precluded extensive study of profitability of payday lending, but available information suggests that returns in payday lending are not excessive. See Mark Flannery and Kathryn Samolyk, "Payday Lending: Do the Costs Justify the Price?" FDIC Center for Financial Research, Working Paper No. 2005-009, 2005; Paige Skiba & Jeremy Tobacman, The Profitability of Payday Loans (Unpublished manuscript 2007), *available at* http://www.cplaacps.ca/english/reports/Vanderbilt%20Oxford%20profitability%20study%2012%2010%202007.pdf ; Aaron Huckstep, "Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?," *Fordham Journal of Corporate and Financial Law*, Volume 12, 2007.

regulation permits market entry, lenders are readily willing and able to enter markets to equate demand with cost-based supply.

Likewise, evidence to be discussed suggests that there does not seem to be market failure due to absence of necessary consumer understanding or knowledge. To be sure, consumers do not necessarily know nor understand everything about lending institutions or loans perfectly. But they also do not necessarily need to know or understand everything about lending for most of them to act in their own interests, even if some do not. Further, Truth in Lending in effect since 1969 provides ready access to information on prices. Individuals also learn from their experiences and can also pass information on to family members and others. Information will be discussed further in the next section and in Chapter 7.

That credit sources are willing sometimes to compete on a non-price basis like preferred hours or greater convenience likewise does not imply market failure. Institutions may try to attract customers by many means, but this does not mean customers are unaware of cost differences. The National Commission on Consumer Finance showed that consumers were aware of differences among credit-providing institutions and the credit-cost alternatives that the market provides. The Commission called this "institutional knowledge" and discussed it on pp. 177-80 of the Commission's *Report*. The Commission found that institutional knowledge extended well beyond knowledge only of the new Truth-in-Lending disclosures.[15] The NCCF also stressed the importance of expanding competition in the small-dollar area, and the landscape is much more competitive today. This enables institutions to compete in a variety of ways and borrowers to choose the ones they prefer. There is no evidence of a market failure on this basis either.

Further, although human nature seems like it has always been able to provide a supply of willing producers of sharp practices (for instance, history also suggests that need for codification of moral codes like the Ten Commandments and others also extend well into antiquity), there does not seem to be a failure of consumer protection in the lending area either. Consumer protection laws in the financial area are quite comprehensive at both state and federal levels. Some individuals may violate the laws, but this does not seem to be the norm. There also is substantial public enforcement. Rather than turning to shady lenders willing to evade or break laws, it is more likely today that constrained potential borrowers will simply move down the list of lenders to a less preferred (higher-cost) credit source if necessary.

[15] See also THOMAS A. DURKIN AND GREGORY E. ELLIEHAUSEN, THE 1977 CONSUMER CREDIT SURVEY, Chapter 3 (1978).

But some observers still do not like laws that permit small-dollar credit with its high costs per loan dollar. Their opponents hold the opinion that overly-restrictive consumer-protection laws can have the unintended consequences of preventing consumers from doing what they want and need or even acting in their own best interest. Ultimately, this is at heart a difference of opinion on the proper role of government in society, also discussed further below. With all this background in mind, it is worth looking at evidence on modern small-dollar lending more closely.

5.3 Common Methods of Providing Small-Dollar Credit Today

Juster and Shay wrote about "primary" and "secondary" consumer lenders, but there actually are many kinds of consumer lenders in what amounts to a continuum in the risk acceptance and pricing dimensions rather than a simple dichotomy. On the low-risk, low-cost end of the lending spectrum, there are prime mortgage lenders, new-auto lenders, and premium credit-card issuers. There even are lenders to highly credit-worthy wealthy individuals purchasing expensive cars, boats, aircraft, and even country club memberships, art, and antiques who prefer not to liquidate other assets to purchase such luxuries.

Credit cards move a bit further out on the risk continuum. Many credit-card purchasers use card services merely for convenience in making payments, even large ones, and repay the amounts quickly upon presentation of the bill at the end of the billing cycle. Other card holders use them as a credit source for purchases of appliances, home furnishings, and home and auto repairs and do not necessarily pay the balance in full when the monthly bill arrives. Some individuals have two or more cards, one for facilitating routine transactions and one or more others used as source of revolving credit.

There even are subprime credit cards used by individuals with poor credit records. Some of them remain poor credit risks but there also are others who use the subprime cards to generate improvements in their credit records with the hope of moving more into the mainstream. And so credit cards are a transitional form on the risk/cost scale. There are many low-risk, mainstream users of credit cards but also some riskier and more costly users. Some users of higher-risk cards graduate to lower-risk credit sources while others do not or even move the other way.[16]

More recent evidence further shows, however, that card holding has fallen from a peak of about three quarters of households in 2001 (see Table 2-2 in Chapter 2), suggesting the possibility of unserved demand in this credit area. Beyond most credit-card credit on the risk scale are the true secondary lenders in the Juster-Shay sense, the high-risk, small-dollar lenders. Discussion of these other sorts of small-dollar credit has been widespread enough recently that today there are many existing descriptions of them ranging from journalistic reports to academic analyses.[17]

Basically, there are four main approaches to non-credit-card, small-dollar lending widely found today and a few others that should also be mentioned. Arrayed from lowest charge per loan dollar to the highest, the four main approaches are: traditional installment cash lending by finance companies at the lower-rate end, and then higher-rate, single payment pawn loans, auto-title loans, and "payday" loans. Some individuals also use forms of "overdraft protection" on deposit accounts for small-dollar credit needs, a source of short-term cash in some aspects like payday loans. These are the lenders and forms of lending that have caused much of the concern among some observers about consumer-credit use in recent years.

Two more credit sources on this end of the risk spectrum are the rent-to-own store and the buy-here-pay-here auto sales outlet. Very little about these latter sources is written in the economics literature. Even beyond them are the illegal lenders, typically still called "loan sharks," that continue to exist according to news reports. They can range from small individual "entrepreneurs" to organized criminal enterprises, the latter especially not a favored research area among the academic community.

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[16] Research following implementation of the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the "CARD Act") showed that about seven in ten individuals in the bottom quartile of credit bureau scores held bank credit cards in 2001, but that the proportion had declined to about half after by the time the CARD Act became effective in 2010 (also following the sharp recession of 2008-9). The research also showed an accompanying increase in cash loans at finance companies among nonprime consumers in states where rate ceilings permitted credit availability from this source. These findings show the apparent substitutability between credit card credit and traditional finance company loans (the latter at higher rates) as credit card credit became less widely available to subprime customers following implementation of the CARD Act and the recession. See Gregory Elliehausen and Simona M. Hannon, *The Credit Card Act and Consumer Finance Company Lending,* JOURNAL OF FINANCIAL INTERMEDIATION (April 2018).

[17] For lengthier academic descriptions of these institutions and kinds of credit, *see* THOMAS W. MILLER, JR., HOW DO SMALL-DOLLAR NONBANK LOANS WORK? (2019) and Bolen et. al. (2020), *supra* note 12. *See also* Durkin, et al. (2014), *supra* note 3, Chapter 8.

Academic and policy interest in other small-dollar lending in recent years means that a list of questions about such lending has developed. Some questions involve research matters and some are more oriented toward policy questions. Research questions include what is the evidence on outcomes of small-dollar loans and whether these borrowers seem to know what they are doing. Research in these areas is ongoing and quite apparently is not going to decide policy debates, but maybe it can inform them. Among the policy questions is concern over the proper role of government in making decisions for individuals. This is discussed in the next section of this chapter.

Looking first at the outcomes issue, Professor John P. Caskey of Swarthmore College articulated his "Big Question" concerning whether small-dollar loans "on net exacerbate or relieve customers' financial difficulties."[18] Most of the recent studies of small-dollar lending focus on payday lending and the payday results have been mixed on this question for them (discussed further below). This is partly due to differences in the specific questions analyzed by the payday studies but also to data and methodology differences (for instance, using aggregate statewide economic data versus surveys of individuals or findings from experimental designs). Ultimately underlying the research results is the inherent variability of outcomes from credit use (its risks), especially where high risk, high rate, single payment loans like payday loans to lower-income consumers are involved. Therefore, research findings do not reveal clear conclusions on Caskey's "Big Question" for all cases or allow easy generalizations.[19]

Overall, research findings on small-dollar lending show that having small amounts of credit available can mitigate costly contingencies ranging from overdraft fees, bounced-check fees, and late fees on unpaid rent and other bills to needs like emergency car repairs and unexpected medical bills. The correct underlying interpretation of the need for a short-term loan is illiquidity that has developed possibly for a combination of reasons.

Surveys show that consumers acknowledge a variety of immediate reasons needing immediate attention. For instance, surveys on payday-loan borrowers reported by the Pew Charitable Trusts found that 69 percent of payday loan users used such loans "to cover recurring expense, such as utilities, credit card bills, rent or mortgage payments, or food; 16 percent dealt with

[18] John P. Caskey, *Payday Lending: New Research and the Big Question* in PHILIP JEFFERSON, ED. OXFORD HANDBOOK OF THE ECONOMICS OF POVERTY (2012).

[19] Interestingly, evidence shows that low income and high risk on the basis of credit score are by no means perfectly correlated, *see* Rachael Beer, Felicia Ienescu, and Geng Li, *Are Income and Credit Scores Highly Correlated?,* FEDS NOTES (August 13, 2018). They are correlated to a degree, however, and even low-income individuals with high credit scores are going to exhaust their credit capacity more quickly than higher-income individuals with high scores, making them riskier for substantial amounts of mainstream credit from primary lenders.

unexpected expenses, such as a car repair, or emergency medical expense."[20] Studies also show that there also appear to be some individuals who exhibit behaviors involving small-dollar credit consistent with present-focused behavioral biases or time-inconsistent discounting of future incomes and spending. These also are hypothesized and sometimes identified by academic behavioral researchers using student subjects, but this is not the overarching reason for small-dollar credit use.

It also turns out that consumer decisions for many small-dollar loans do not require some sort of difficult financial mathematics for users to make informed decisions about potential outcomes. Reasons for using the credit typically are very immediate and clear: some sort of illiquidity. For instance, few things are clearer than emergency conditions or an immediate need with little or no cash available. The emergency is obvious and the cost of a loan is readily available and easy to ascertain, even if future outcomes can vary from expectations. Further and significantly, Truth-in-Lending requirements mandate cost disclosures both in dollars ("finance charges" in TIL terms) and as an Annual Percentage Rate. Even the skills of a certified financial analyst would not lead to different decision parameters in these situations: Often the short time period means that discounting the cash flows is little different from undiscounted cash flows. Even at high rates, entering calculations of time value of money as a financial analyst might do would cause few analytical reversals of benefit/cost criteria or require sophisticated financial review.[21]

Survey evidence also shows that many users are aware of the main features of the loan products. For instance, evidence from a variety of surveys shows that borrowers typically understand the dollar-cost of the loans, also discussed further below. This means that users are easily aware of both the benefits and the cost and provides the context for use of the credit and its potential outcome. Unfortunately, looking closely at choices and outcomes for large numbers of specific individuals by researchers is generally not easily possible due to lack of much survey information on outcomes at the individual level. Research findings are discussed further in the following subsections on individual products.

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[20] PEW CHARITABLE TRUSTS, PAYDAY LENDING IN AMERICA: WHO BORROWS, WHERE THEY BORROW, AND WHY (2012).

[21] Textbooks on finance discuss the concept of time value of money and the role and methods of financial analysis in more detail. For discussion in the context of payday loans see GREGORY ELLIEHAUSEN AND EDWARD C. LAWRENCE, PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND (Washington: Georgetown University Credit Research Center, Monograph Number 35, 2001), also summarized in Durkin, et al (2014), *supra* note 3, Chapter 8, 370-4.

Traditional Installment Cash Lenders

Beginning with the lowest-rate source for small-dollar credit, one type of small-dollar lender still somewhat common today in some states is the traditional cash installment lender. This sort of lending is considerably older than payday and auto-title lending industries and has its own approach and heritage. Notably, the traditional small-loan industry makes loans with repayment over multiple months with repayment designed to fit into monthly budgets more smoothly than lump-sum repayment.

As indicated earlier in Chapter 2, small cash loans to individuals for household purposes became common in the United States in the years after the Civil War, mostly illegally at first. By the 1910s, abuses produced a public reform effort led by the Russell Sage Foundation and it conceived the regulated small-loan industry. In the past, these companies were known as licensed lenders, small loan companies, or consumer finance companies. In the states where it still exists, this industry today typically is called the traditional installment cash-loan industry to differentiate it from the other small-dollar lenders.

These lenders make relatively small cash loans to individuals for periods usually from six months to about two years with interest rate ceilings specified in state lending laws. Because of the unsecured nature of these loans and their longer maturities and slower payment schedules, the lenders evaluate the employment and budget condition of potential borrowers more carefully than the other small-dollar lenders (called "underwriting" the loans).

Typically, the allowed rate within states varies somewhat by loan size, with higher rates allowed on smaller loans in some states. Because the National Commission on Consumer Finance discussed them at length and since lending-cost data on these lenders exist, Chapter 4 of this Taskforce report examined cost aspects of their lending in more detail. Rate requirements on the smallest loan sizes for short terms and annualized under TIL rules can exceed 100 percent APR, but more typical are somewhat larger loans at considerably lower rates.

Traditional small cash installment loans occupy a middle ground between mainstream installment credit from banks and other primary lenders including credit cards and small single-payment loans like pawn and payday transactions. Traditional small installment loans are not the same as the other forms of small-dollar credit, despite how they are sometimes lumped together. Payday loans arose from the check-cashing industry as a "payday advance" procedure requiring single-payment payoff redemption. Pawn loans and title pawns have different heritages, but also have reflected the plan of a single-payment payoff within a short period of time. Evidence suggests that where laws still allow small-dollar versions of traditional installment cash loans to exist, lenders also supply them and demand finds them.

As indicated in Chapter 2 and here, traditional installment lending industry arose from the ultimate background of the reforms sponsored by the Russel Sage Foundation in the 1910s. At the time, the reforms allowed for exceptions to prevalent state rate ceilings on loans of $300 and less that permitted small loans to be made with repayment in installments. Allowed rates varied according to state, but reached 42 percent on the smallest sizes in an early version from the Sage Foundation. Today, traditional installment cash lenders typically make small cash loans at the sorts of rates suggested as necessary by the NCCF in 1972 (see discussion in Chapter 4 above).

Statistical review in the previous chapter suggests that a ceiling of 42 percent today would not allow these lenders to engage in making such loans smaller than about $2000 and still cover all costs (see Table 4-2 in the previous chapter). Thus, finance company installment loans at the larger end of the size spectrum are going to be more prevalent in states allowing rates at the lower end of the rate spectrum, as they were at the time when the Sage Foundation was lobbying its reforms. Today some states allow for sufficient rates on smaller loan sizes to permit lenders to make smaller loans, but lending laws that once encouraged this reform have atrophied in many places. This happens if limits on loan amounts permissible special (higher) rates do not keep pace with inflation.

An extreme hypothetical example can clarify this point: If in some state the loan size ceiling of $300 at a 42 percent rate had not been raised above this size limit since 1916, there would be no loans in this state today under this law. As the table in Chapter 4 shows, lenders would not be willing to make loans in this market below a size of about $2000, but the legal size limit would not permit loans larger than $300. Thus, there would be no lenders (and no loans) at the atrophied legal limits of $300 and 42 percent in this state. Filling in a larger loan size limit in the example up to about $2000 would produce the same result.

There has been only limited research on the traditional installment cash lending industry in recent years, mostly, like with other forms of small-dollar lending, because of lack of data such as surveys of borrowers. There is only limited information even about where such traditional installment lending takes place and in what volumes. At the time of the NCCF, much more information was available from state regulators. Some studies at the time used this available statewide data, and the NCCF undertook additional data gathering and research studies on this industry.[22]

[22] A selection of economic, historical, and statistical studies of the installment cash lending industry available to the National Commission in 1971-2 included, among others: ARTHUR HAM, THE CAMPAIGN AGAINST THE LOAN SHARK (1912); Rolf Nugent, *Three Experiments with Small Loan Interest Rates*, HARVARD BUSINESS REVIEW (October 1933); LOUIS N. ROBINSON AND ROLF NUGENT, THE REGULATION OF THE SMALL LOAN

More recently, Durkin, Elliehausen, and Hwang used information from a survey of traditional installment cash lenders undertaken by the American Financial Services Association to report characteristics of more than 3.1 million small-dollar traditional installment loans made in the second half of 2013.[23] They reported many of the key findings about these surveyed loans in a summary attached to their paper. Discussion included how these loans are found in states where rate ceilings on smaller loan sizes are similar to those the National Commission on Consumer Finance calculated in 1972 were necessary before such loans would be available. Few loans were found in states with lower ceilings (see their summary, pp. 2-3):

> Findings from the AFSA survey of installment lenders are consistent with hypotheses developed many years ago from the economic theory of credit rationing. These hypotheses suggest that users of small dollar amounts of installment credit from secondary credit sources are "rationed" borrowers in an economic sense, those borrowers unable to obtain as much credit as they need or want from primary lenders at low rates. Specific findings include:
>
> Most loans (more than 85 percent) clearly are subprime on the basis of credit scores. (Sixty-eight percent had credit scores below 620 and 24 percent were below 551).
>
> These installment loans are both small and short term. Almost 75 percent of the surveyed loans are made for $2000 or less and 77 percent for two years or less. These are precisely the loans the federal study commission [the NCCF] determined would require high rates.
>
> High APRs are due to both small size and high risk.

BUSINESS (1935); THOMAS G. GIES, CEDRIC V. FRICKE, AND MARTHA SEGER, CONSUMER FINANCE COMPANIES IN MICHIGAN (Ann Arbor, MI: Bureau of Business Research, University of Michigan, 1961); Paul F. Smith, *Recent Trends in the Financial Position of Nine Major Consumer Finance Companies* in THE CONSUMER FINANCE INDUSTRY: ITS COSTS AND REGULATION, (eds. John M. Chapman and Robert P. Shay 1967); PAUL F. SMITH, CONSUMER CREDIT COSTS 1949–1959 (1964); IRVING S. MICHELMAN, CONSUMER FINANCE: A CASE HISTORY IN AMERICAN BUSINESS (1970); JOHN M. CHAPMAN AND ROBERT P. SHAY, LICENSED LENDING IN NEW YORK (1971); and Thomas A. Durkin, *A High Rate Market for Consumer Loans: The Small Small Loan Industry in Texas,* TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, Volume II, Number 3 (1973).

[23]Thomas A. Durkin, Gregory Elliehausen, and Min Hwang, Rate Ceilings and the Distribution of Small-Dollar Installment Loans from Consumer Finance Companies: Results of a New Survey of Small-Dollar Cash Lenders, (2014, available on Social Science Research Network). Before discussing their statistical findings about these loans, the authors further reviewed Juster and Shay's analysis of how credit rationing would likely involve lower income and younger consumers most often.

> Loans are made with low payments to satisfy both demand among rationed borrowers for small payments and supply by lenders who also are interested in easy repayment. Almost 40 percent of the loans have payments of $100 or less monthly and almost 75 percent $150 or less. ...

Durkin, Elliehausen, and Hwang also found that frequency of this lending varied sharply among states. States with low ceilings have few loans, larger average loan size, and longer maturities. The finding that states with low ceilings have larger average loan size is consistent with the hypothesis that where permitted rates are lower, borrowers and lenders will work toward adjusting terms. Adjustments tend to increase the principal amount borrowed in order to reduce the Annual Percentage Rate of the loan to come in under the legal rate ceiling. To keep payments manageable on larger loans, maturities could be lengthened, but these changes would result in higher costs (total finance charges) for the consumers, even at a lower APR. Durkin Elliehausen, and Hwang offer examples of these adjustments in their paper. Such larger and longer loans also would likely only be available to the better credit risks.

As previously discussed, (with examples) in Chapter 4, such adjustments that rate ceilings cause can be harmful to consumers desiring smaller loan amounts of credit. First, some higher-risk consumers who could qualify for a loan at a smaller principal amount will not be able to qualify at the larger minimum loan size. Second, adjusting to larger loans for a longer period can force higher total finance charges than if they were permitted to borrow only the amounts they needed. The National Commission on Consumer Finance and the Russell Sage Foundation before it understood this.

Durkin, Elliehausen, and Hwang provided examples. The found that in Pennsylvania, which has a low maximum permissible rate, there were few installment loans — just 1.5 per 1000 population. Moreover, there are almost no loans for less than $500 and only 1 percent of loans for under $1000. Fifty-seven percent of loans had maturity lengths greater than two years. As a result of these larger loan amounts, 55 percent of loans had monthly payments in excess of $150 per month.

The authors compared experience in Pennsylvania to Texas, which allows higher APRs on small installment loans. In Texas, there are many more loans — 23.9 per 1000 population. Forty-two percent of loans were for under $500 and 70 percent were under $1000. Finally, 99 percent of loans had maturity periods shorter than two years. Because of the smaller loan sizes, only 16 percent of borrowers had payment obligations of greater than $150 per month. And smaller loans for shorter intervals reduce finance charges.

The authors also found that the delinquency rate in the survey of installment loans was high, with the highest slow-pay experience on the smallest loans sizes. Delinquency there ranged up to more than 25 percent, although undoubtedly many of these loans paid off, even if slowly and only after costly and time-consuming reminders. Borrowers with the lowest credit scores qualified for only the smallest loans.

In recent years, online installment lending of "payday-type" loans has also grown rapidly and should not be confused with "traditional" installment loans.[24] Although there is little systematic research of these newer payday-installment loans, available information suggests that these online installment loans are, on average, larger in size than those made by traditional storefront payday lenders, and have substantially higher rates of fraud and chargeoffs than such traditional storefront payday loans. Online borrowers also appear to have higher incomes than traditional storefront payday borrowers, consistent with the finding that they are also more likely to borrow larger sums.[25]

Pawn Lenders

The oldest of the small-dollar lenders is the pawn lender, dating at least to the ancient Greek city states. In a pawn transaction, the borrower brings an item to the lender and leaves it there for a fixed length of time in exchange for current cash (the loan amount). Simultaneously, the borrower agrees to repay the loan in full with interest in a set amount of time (redeem the pawn), usually in a month, at which time the borrower receives back the pawned item. There is no true obligation actually to repay the loan and redeem the item, however. Instead, the borrower may simply walk away, in which case the pawn broker may sell the pawned item (or sometimes auction it if required by state law).

Explained this way, a pawn arrangement is a single transaction, a secured loan for one month. But it is also closely akin to and can be structured as two transactions: first a sale of the good by the individual to the pawn broker with agreement by the individual to buy it back later in a second transaction for a higher price. This sort of "lending" was done in the middle ages when true lending with interest was prohibited. The repurchase later at a higher price takes the place of returning the loan principal with interest. Robinson and Nugent (1935) reported that this sort of transaction was common in the "loan shark" period of domestic consumer credit before about

[24]See Howard Beales and Armand Goel, *Small-Dollar Installment Loans: An Empirical Analysis*, Working paper (2015), available SSRN: https://ssrn.com/abstract=2581667.

[25]See G. Michael Flores, *The State of Short-Term, Online Lending*, BRETTON WOODS, INC., (2015).

1910. At the time, a succession of such one month "loans" could extend the transaction for much longer than a month.[26]

Because this second possibility could potentially produce abusive situations even amounting to extortion by lenders holding on to the goods instead of allowing their timely return, state laws typically require that pawn-shop transactions be structured clearly. They must be either loans with specified terms, conditions, and requirements, including the lending period and maximum amount of finance charge, or true sales. Because pawned items often are not redeemed, however, ordinary pawn loans also often become sales to the lender (or auctions) to recover the loan amount and interest. In fact, a good way of thinking about a pawn loan is to think of it really as a sale for cash now (by the "borrower") with the option to cancel the sale next month and get the item back by repaying the "loan." Described this way it should not be surprising that "defaults" are relatively common: the "borrower" simply decides later to go through with the sale.

Because in some large sense pawn transactions are not really loans, pawn "lenders" rely on the value of the pawned item for security and do not investigate income or credit status of the "borrower." Goods that are easily transportable, like jewelry, musical instruments, and electronic items, are common pawn offerings today. Typical maturity is one month with a common fee of twenty percent of the loan amount (annualized by Truth in Lending requirements as an Annual Percentage Rate (APR) of 240 percent). The pawn charge includes interest but also fees for secure storage of pawned pledges, since the pawnbroker is liable for damaged items and must provide storage space and facilities. There also are special regulatory requirements including records for law enforcement to prevent pawning or sale of stolen goods.

There is not much recent research information on pawn lending, but there is some.[27] Concerning pawn borrowers, survey information suggests they are probably the weakest borrowers financially (Table 5-1). Casual industry commentary suggests that pawn lending frequently

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[26]See ROBINSON AND NUGENT (1935), *supra* note 21.

[27]See Robert W. Johnson and Dixie P. Johnson, *Pawnbroking in the US: A Profile of Customers*, GEORGETOWN UNIVERSITY CREDIT RESEARCH CENTER, Monograph Number 34 (1998); Robert B. Avery and Katheryn A. Samolyk, *Payday Loans Versus Pawn Shops: The Effects of Loan Fee Limits on Household Use*, Social Science Research Network Working Paper, (2011), and Marieke Bos, Susan Payne Carter, and Paige Marta Skiba, *The Pawn Industry and Its Customers: The United States and Europe*, Law and Economics Working Paper 12-26, Vanderbilt University Law School (2012).

involves customers that would often not be of interest even to payday lenders due to risk. Bolen, Elliehausen, and Miller report much the same:[28]

> Pawn borrowers are often in worse financial condition than those who use vehicle title loans or payday loans. They have lower incomes, more difficulty paying bills, and higher spending relative to income than vehicle title and payday borrowers. Pawn borrowers are also less likely to use auto loans, student loans, and credit cards than vehicle title and payday borrowers.

This worse financial condition than even other small-dollar credit users probably accounts for their use of pawn: As indicated, the pawn loan often amounts to the conditional sale of an asset owned by the borrower with a short-term *option* to buy it back in a month or so (presumably if conditions improve), by redeeming the item through paying off the pawn loan. Evidence also suggests that rate ceilings on pawn lending restrict the number of pawn shops and the amounts that lenders are willing to advance on pawn loans, although demographics are also important.

For many consumers, pawnbrokers are among the least-attractive options. In addition to being forced to pledge some item of personal property, the average size of pawn loans is much smaller than for other types of alternative lending, reflecting the reality that many of the items pawned are used consumer goods with modest resale value. Studies have found that the average size of a pawn transaction is only about $70-$80, a size of limited utility for meeting most financial obligations. Pawnbrokers are often patronized by consumers who do not have bank accounts, because many other types of small-dollar loans (such as payday loans and bank overdraft protection) require a bank account.

Automobile Title Lenders

The third kind of small-dollar lending common today is the automobile title loan, sometimes called a "title pawn." It actually is a new variation of pawn lending in recent decades. In this transaction, the borrower brings the legal title of an automobile or truck to the lender and receives a short-term loan based on it. Necessity of holding clear title suggests that most title pawns are mostly going to involve older vehicles with no other loans and liens.

A few differences from the traditional pawn loan are evident: First, the borrower keeps possession of the vehicle and leaves only the ownership document with the lender. Second, this difference in possession makes the transaction more akin to a secured loan for the lender but

[28] Bolen et. al. (2020), *supra* note 12.

with the physical item of security not in the lender's possession and highly mobile. This enhances lending risk, since in case of default the security is not readily available for sale or auction without a repossession-like undertaking. Rates of twenty percent per month (240 percent APR) also are common in title pawns, but typically involving larger loan amounts than traditional pawns.

Like other pawns, most title pawns are made for one month, with payment of principal and interest at the end of the month (renewals for an additional month or months often occur). Some loans are made allowing for a succession of payments until full repayment is achieved (known as "vehicle-title installment loans," and again not to be confused with traditional cash installment loans from finance companies). Multi-month loans at title-pawn rates are going to be more costly for the individual than a single-month loan of the same amount.

Like normal pawns of smaller items left with the pawn broker, it is possible to think of a title pawn as a conditional sale of the vehicle by the "borrower" with a monthly option to reclaim the sold vehicle for the sale price (the loan amount) plus an option fee (legally, the pawn interest). Again it is not too hard to imagine that "defaults" are going to be common: the "borrower" simply goes through with the sale by walking away from the transaction (i.e. "defaults").

Empirical evidence suggests that "defaults" are common on title pawns. Undoubtedly, some occur because the borrower would like the car back but cannot make the payment. Others likely occur because the borrower prefers to keep the sale price (loan amount) rather than keep the old car, especially if it needs repairs. This conveniently puts the burden of getting rid of an unwanted car onto the lender. In some cases the vehicle is not even worth repossessing for the lender and it becomes a complete loss to both "borrower" and "lender."

Title pawns tend to be larger than pawn loans or payday loans due to the motor vehicle used as collateral. In 2016 the CFPB reported from a large sample that median size was about $700 with mean $959 due to some loans being much larger.[29] Nonetheless, Hawkins found that 57 percent of title pawn customers do not have banking relationships.[30] Industry sources report informally that many might be recent immigrants.

Some evidence suggests that a portion of title pawn lending involves short-term business loans. In a 2010 study Zywicki assigned title pawn borrowers to three classes: small business owners

[29] CONSUMER FINANCIAL PROTECTION BUREAU, SINGLE-PAYMENT VEHICLE TITLE LENDING, 6 (May 2016).

[30] See Jim Hawkins (2012), *supra* note 9.

like landscapers who use their vehicles as a source of short-term working capital, moderate-income borrowers with poor credit histories, and low-income consumers with needs and credit problems.[31] Others examining other locations and circumstances have found borrowers with lower incomes and less evidence of business-related borrowing purposes. The nationally representative survey in 2015 referred to earlier in Table 5-1 found title pawn customers to be somewhat higher-income than payday and pawn customers with somewhat more use of mainstream consumer credit, but many still within the demographic categories where credit rationing is more likely (see Table 5-1 and sources).

Historically, both pawns and title pawns share the difficulty of payday loans that they are inherently single-payment loans, making full repayment after a short time period inherently difficult in some cases. This means that full repayment may sometimes take a while, leading to a sequence of monthly renewals for this while. Defaults also are common in both short and longer title lending, but, as indicated, some defaults and even automobile repossessions on title pawns really amount to sale of the pledged item to the lender after time to consider this possibility further. As indicated and like other pawns, a title pawn can act like a conditional sale to the title lender for the loan amount, with a (renewable) option to repurchase the car by paying off the loan later. It seems possible that the borrower would be more likely to let the car go and end the sequence of monthly options when a pawned vehicle suddenly needs some new (expensive) repair or attached equipment like tires.

Most cars that are pledged as collateral for a title loan are old; Hawkins found that the average car pledged was approximately 11.4 years old and had over 90,000 miles. He also reported that the majority of auto title loan customers own more than one car and virtually all title pawn customers have access to alternative transportation if they lose their car as part of the loan.[32] Owing to their age and condition, many defaults on auto title loans result from a major mechanical failure or major accident to the car. In fact, only about half of defaults result in repossession of the vehicle because following a major incident its value can be less than the cost of repossessing and reselling it.[33] According to one survey, 8.5 percent of title pawn customers report that they would be forced to sell the car if they were unable to obtain an auto title loan.

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[31] Todd J. Zywicki, Consumer Use and Government Regulation of Title Pledge Lending, LOYOLA CONSUMER LAW REVIEW, No. 4 (2010).

[32] *See* Jim Hawkins (2012), *supra* note 9. Interestingly, almost 9 percent of auto title loan borrowers in the survey reported that if they lost their car they would simply buy another one.

[33] See Todd J. Zywicki (2010), *supra* note 30.

That figure exceeds the percentage of borrowers who lose their vehicle to repossession for failure to pay, but those forced to sell their cars lose possession immediately and with certainty.[34]

Apparently to combat this rollover element of such lending that has been objectionable to some observers, and, presumably, in anticipation of a proposed CFPB rule with the potential effect of limiting short-term single-payment loans, the industry trend has been toward loans with multiple payments (title installment loans). Greater prevalence of loans repayable in multiple payments does not make such loans similar to traditional cash installment loans, however, since the payday, pawn, and title-pawn multiple-payment loans are made at much higher APRs. From the "lender's" perspective, pawn and title pawn "loans" are not even dependent upon the income or cash flow of the borrower, but rather depend upon the value of the pawned item.

There has been a small amount of survey research on the experiences of title-loan customers, focusing especially on aspects of the decision process such as overconfidence about repayment ability with the planned time and time preference itself.[35] Because of data limitations it was not possible for the authors to provide definitive conclusions, but (like findings in the payday area examined next) they found evidence that many borrowers could make reasonable estimates of potential time to full payoff but with some evidence of present bias and a range of outcomes. They also found some evidence of learning about repayment times through experience. They found that about a fifth of borrowers were overtly present-biased in their estimation, but by no means everyone or even close to a majority.

Payday Lenders

"Payday" loans are the fourth kind of small-dollar loan widely available and the newest basic type other than title pawns that really are a variation of older pawn lending. Payday lenders grew in recent decades out of the check-cashing industry. Check cashers developed to cash paychecks, for a fee, for workers who for one reason or another had no bank relationship for deposits or check cashing (or for whom common banking hours were inconvenient). It was only a small step to start "cashing" paychecks early for a somewhat larger fee. Due to a variety of regulations including Truth in Lending, such actions amounted to lending under state and federal laws. This would be controversial enough by itself, but annualizing these fees as required by TIL and then extending longer terms and providing rollover possibilities made them even

[34] The Consumer Financial Protection Bureau reported a 3 percent repossession rate and Hawkins 4-6 percent.

[35] See Kathryn Fritzdixon, Jim Hawkins, and Paige Marta Skiba, *Dude, Where's My Car Title: The Law, Behavior, and Economics of Title Lending Markets*, UNIVERSITY OF ILLINOIS LAW REVIEW (2014).

more so. A fee of fifteen percent on a loan of two weeks is common (annualized under TIL rules as 391 percent APR).

Evidence shows that payday borrowers are overwhelmingly subprime with an average credit score of 520.[36] As discussed above, they lack current access to credit-card credit and many have searched extensively for credit elsewhere. Most do not have liquid savings available.

Recent tendencies in the payday loan industry include payday loans with repayments made in installments over time. While superficially such loans appear similar to traditional installment loans, installment payday loans are made under provisions of payday lending laws, at much higher TIL percentage rates and finance charges than traditional installment cash loans of the same size and maturity. Another more recent trend is toward making payday loans online over the Internet instead of only at storefronts. This approach contemplates making payday loans across state lines as well as locally. Available evidence suggests that online payday loans are the riskiest and highest-cost form of institutional consumer lending.

As indicated, most of the studies on outcomes of small-dollar credit in recent years involve payday lending. Using datasets not necessarily always originally designed to address questions on the impact of payday lending directly, studies over the past fifteen years have found usefulness of payday lending in reducing bounced checks and costly overdraft fees, Chapter 7 and 13 bankruptcy filings, and debt-collector harassment. One study found increases in Chapter 13 filings with payday lending but the authors also recognized that filings "depend on difficult-to-estimate parameters like private and social net costs of bankruptcy filings." [37]

Some studies found favorable impact of availability of payday lending on other aspects of financial well-being defined in a variety of ways at the state level and other studies found little impact. There also are differences in findings concerning impact of payday lending on military preparedness using different definitions of preparedness and different data. The most recent study, using better data, concludes there is no evidence of a favorable impact on military preparedness of the ban on payday lending to the members of the military.[38] Some studies

[36] See Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman (2015), *supra* note 8.

[37] Paige Marta Skiba and Jeremy Tobacman, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default,* Vanderbilt Law and Economics Research Paper 08-33, 26 (2008). One problem with trying to determine the relationship of payday loans with financial distress is that it is not always clear whether high-cost loans are a cause or effect of distress. For instance, do they push a borrower into bankruptcy or are they the last resort in trying to avoid bankruptcy which is likely to occur anyway as a result of other conditions.

38Susan Payne Carter and William Skimmyhorn, Much Ado about Nothing? New Evidence on the Effects of Payday Lending on Military Members, REVIEW OF ECONOMICS AND STATISTICS (October, 2017).

indicate that payday loans are a response to financial difficulties and not the proximate cause. Various studies have shown that payday borrowers typically do not have other credit available at the time of the loan.[39]

By themselves, these findings on balance appear to support the usefulness of payday lending in many situations, but they do not satisfactorily answer Caskey's Big Question: Even if findings were generalizable, there still is a significant range of possible outcomes at the individual level from highly favorable to highly unfavorable. This simply outlines the nature of the problem that financial regulators and legislators face, "a difficult trade-off between the benefits of regulation to households that make mistakes, and the costs of regulation to other financial market participants."[40]

Another line of investigation of payday lending has involved the implications of payday-lending heritage as single-payment loans payable a short period of time after the loan is made. This naturally raises the question how an individual who cannot pay for some emergency today is going to be able to make the payment a short while later, this time with an extra fee to cover the charges on the payday loan. An intervening paycheck is the answer, but what if that entire paycheck is already earmarked for other necessary expenditures (including payment of non-payday debts or other payday loans) or it is smaller than expected due to variations in employment hours of hourly workers, or even unavailable?

Analysts at the Consumer Financial Protection Bureau and elsewhere have examined this question and have attributed the frequency of renewals on payday loans as evidence of users' frequent inability to repay in full in single payments a short time later.[41] This is undoubtedly true in some cases, but some borrowers also do not extend their loans and many do appear to have understood this likelihood in advance.

39For lengthier summary of these studies and detailed references, see Bolen et. al. (2020), supra note 12, 23-6, and Durkin, et al. (2014), supra note 3, Chapter 8, 386-94.

40John Y. Campbell, Restoring Rational Choice: The Challenge of Consumer Financial Regulation, AMERICAN ECONOMIC REVIEW, 25 (May, 2016). Immediately following this quotation is Campbell's concluding sentence: "The task for economists is to confront this trade-off explicitly, bringing to bear the highest quality evidence that modern applied microeconomics can make available." Reviewing available earlier studies on payday lending, Allcott, et al. raise the same point as Campbell in a new working paper in 2020 discussed further below: "Such analyses are difficult to use for welfare evaluation because it is not clear how to trade off effects on different outcomes or include other unmeasured welfare-relevant outcomes" (Alcott, et al., p. 5).

41See CONSUMER FINANCIAL PROTECTION BUREAU, PAYDAY LOANS AND DEPOSIT ADVANCE PRODUCTS (April 24, 2013); CONSUMER FINANCIAL PROTECTION BUREAU, CFPB DATA POINT: PAYDAY LENDING, (March 2014); PEW CHARITABLE TRUSTS, PAYDAY LENDING IN AMERICA (Three reports, 2013); CENTER FOR RESPONSIBLE LENDING, THE STATE OF LENDING: PAYDAY LOANS (2013).

Available evidence suggests many payday borrowers are aware of important information for making decisions. For instance, Elliehausen and Lawrence (2001) found that up to 98 percent of surveyed payday borrowers reported dollar costs of their loans that could be deemed accurate (precise measurement of accuracy would require availability of the loan documents, which the authors did not have). In contrast, they reported that only 20 percent of borrowers could report an accurate APR, although they indicated that most borrowers recalled receiving information on the APR. They concluded that borrowers considered the finance charge as the important indicator of the cost of the credit. In a study using an experimental design, Bertrand and Morse reached a similar conclusion in 2011.[42] This is not surprising since these loans are simple products with one price, a single finance charge at the outset (or at a rollover) compared to other loans that might have multiple components and fees.

The finding that the finance charge in dollars is an important concept to small-dollar borrowers actually considerably predates the beginnings of the payday loan industry. In other contexts, Due (1955), Juster and Shay (1964), and Durkin (1973) noted similar empirical findings.[43] These results suggest, reasonably, that the APR is not the only credit-price information that consumers may need or use to make credit decisions (also discussed here in Chapter 4). Congress understood this when it passed Truth in Lending in 1968, mandating disclosure of both the finance charge in dollars and the APR.

Before Truth in Lending, Wallace Mors (1965) had assessed the usefulness of various types of financial information and charges in a study for the National Bureau of Economic Research. He proposed that ideally consumers needed the dollar amount of finance charge, the size and number of monthly payments, and the annual effective finance rate (in TIL now known as the APR, functionally the annual unit price). He examined the use of these items in evaluating loan contracts having different loan amounts and terms to maturity. He concluded that none of the items can serve effectively as a single criterion, because each applies only to some aspect of the credit decision.[44]

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[42] *See* ELLIEHAUSEN and LAWRENCE (2001), *supra* note 20; and Marianne Bertrand and Adair Morse, *Information Disclosure, Cognitive Biases, and Payday Borrowing,* JOURNAL OF FINANCE (November 2011).

[43] Jean Mann Due, *Consumer Knowledge of Installment Credit Charges,* JOURNAL OF MARKETING (October 1955); JUSTER AND SHAY (1964), *supra* note 2; Durkin (1973), *supra* note 21.

[44] WALLACE MORS, CONSUMER CREDIT FINANCE CHARGES (New York: National Bureau of Economic Research, 1965). Mors also considered computational rates (used in mathematical computational formulas) in his analysis, but even before Truth in Lending using some kinds of underlying computational rates for disclosures was generally not legal unless they were also effective rates or specifically allowed by state law.

Regarding small, short-term loans, he noted that annual finance rates are very high even when the dollar finance charges are nominal. As discussed here above in Chapter 4, this happens because largely fixed costs of acquisition and servicing are spread over a small amount of credit for a short maturity period. He further pointed out, as had Juster and Shay, that for evaluating loans of the same amount and maturity, finance charge, monthly payment, and APR are perfectly correlated. This means that in evaluating credit arrangements between and among lenders, focusing on the finance charge or the monthly payment amount also provides important information for comparisons in many cases.

Chapter 4 of this *Report* also noted briefly that on small-dollar loans the finance charge is also useful for another important comparative reason. Namely, when considering a short-term loan for a current need, the need or emergency is normally going to be very immediate and obvious. By examining the finance charge instead of the APR, the cost/benefit comparison of whether or not to employ the credit quickly becomes apparent as well. Hence, there is no surprise that those seeking such loans tend to focus more on the finance charge than the APR. This discussion is by no means intended to denigrate the importance of the APR but rather merely to refer back to Mors who pointed out before TIL that no single disclosure provides all the information about a credit arrangement. The finance charge, monthly payment, and APR serve different needs, but all are now required disclosures under TIL.[45]

Turning to another aspect of payday lending/borrowing, an interesting new paper by Allcott, et al. explored, among other things, whether payday loan borrowers correctly predict the amount of time it will take them to repay their payday loans, the rollover problem noted by the CFPB.[46] This is an important question for both consumer welfare and regulatory policy. If borrowers make accurate predictions of their repayment prospects (for instance, knowing that they will not be able to repay in full on the initial due date of the loan necessitating one or more renewals before repayment), then they can better estimate the complete costs and benefits of their payday

[45] For a complete discussion of evaluating investments that provide benefits for the future including the theoretically correct way of using APRs to calculate net present values, see the well-known text on financial analysis by Bierman and Smidt (2006). Fortunately, since virtually all consumers will not find net present values either intuitive or easy to compute, APRs may also be used for unit-price comparisons of similar credit arrangements among creditors. Bierman and Smidt also note at the outset of their ninth edition that complex analyses are unnecessary for choices in which benefits are received in a short period: "If benefits are likely to accrue reasonably soon after the expenditure is made, and if both the expenditure and benefits can be measured in dollars, the analysis of the problem is more simple than if the expected benefits accrue over many years and there is considerable uncertainty as to the amount of these benefits," see HAROLD BIERMAN, JR. AND SEYMOUR SMIDT, THE CAPITAL BUDGETING DECISION: ECONOMIC ANALYSIS OF INVESTMENT DECISIONS, 9th ed., 2 (2006).

[46] HUNT ALLCOTT, JOSHUA KIM, DMITRY TAUBINSKY, AND JONATHAN ZINMAN, ARE HIGH-INTEREST LOANS PREDATORY? THEORY AND EVIDENCE FROM PAYDAY LENDING (March 9, 2020).

loan than otherwise. If, in turn, they do not understand or predict the likelihood of renewals, then inability to repay and a cycle of unintended renewals can force borrowers into unexpected "debt traps" that, in addition to high APRs, are among the main complaints about the payday industry by advocates and various political figures.

In designing their study, Allcott, et al. had the advantage of reviewing and understanding earlier studies and how gaps in understanding this market had developed for lack of data and other reasons. For instance, they easily recognized that findings about whether borrowers understood what they wanted to do did not necessarily mean they *should* want to do it in the eyes of advocates and regulators. This encouraged a sophisticated research design by Allcott, et al. that connected such considerations as theory of life-cycle spending patterns, time value of money, risk aversion, and the potential bias of present focus or not of individual borrowers. They also surveyed and studied the relation of borrower experiences to the predictions of experts.

Data were specifically gathered for this project and involved a careful control-group experimental design (with a meaningful rewards component and size sufficient for statistical statements). As indicated, there were surveys of both borrowers and outside experts. Participation of a large payday lender allowed comparisons of experimental results with actual borrowing experience. The authors acknowledged that participation of only one lender could produce the complaint that customers might not be representative of all lenders and situations, but the project seems large enough to be importantly indicative, using forty-one separate payday storefronts.

Significantly, findings showed that borrowers predicted quite well the likelihood of reborrowing within a short period of time. This echoed the findings of Ronald Mann in a less-sophisticated and smaller pioneer study in this area some years earlier. Mann also found that most borrowers expected to extend the loan after the first period and predicted the final repayment date with some accuracy. He also found that errors made were in both directions and not just indicative of underestimating.[47]

Further, Allcott, et al. found that borrowers appeared to learn with experience, predicting better after previous experience, "more experienced borrowers predict exactly correctly on average" (p. 3). The authors argued that this experience component in prediction may suggest the reason why other, purely-experimental research designs, have found poorer predictive ability. They also reported that their panel of experts (including both academics and payday lenders) predicted

[47] Ronald Mann, *Assessing the Optimism of Payday Loan Borrowers*, SUPREME COURT ECONOMIC REVIEW (2013).

considerably worse performance by borrowers in forecasting their payday loan payment patterns than predictions by payday borrowers themselves.

Although not the main focus of their work, the authors suggested that findings have implications for policy in this area. After not finding that behavioral biases of payday borrowers make them unable to predict future borrowing, the authors contended that outlawing payday lending lessens consumer welfare (p. 3):

> We first provide theoretical propositions that give qualitative intuition for optimal policy. A payday loan ban can only harm time-consistent or sophisticated borrowers, as they correctly predict their future repayment when initially deciding how much to borrow. However, with limited uncertainty in repayment cost shocks, a ban benefits *persistently* naive borrowers, as they fall into "debt traps" where they continually reborrow because they falsely believe they will repay in the next period. If borrowers are *temporarily* naive and become sophisticated, as in our empirical estimates, the losses from overborrowing are tightly bounded, and a ban is again likely to be harmful [emphases in original].

As indicated, the authors noted that their results contrasted sharply with the prior beliefs of their panel of experts that contended that borrowers would be much more naive than they actually were.

Overdraft Protection

Overdraft protection on depository accounts is a service similar in some ways to payday loans. Like payday loans, overdraft protection provides small amounts of credit for a short time to individuals with liquidity difficulties. Unlike payday loans, the individuals must be current customers of the specific bank or other depository institution that provides the overdraft protection, suggesting customers are not drawn from the very poor. Overdraft protection is provided by depository institutions like banks that hold the customers' transaction accounts, but otherwise banks have never provided much small-dollar credit (except through credit cards), largely for cost, reputation, and regulatory reasons.

Under common overdraft protection plans, the bank or other depository agrees to cover overdrafts with a transfer of funds from another deposit account owned by the customer (like a savings account) or from a prearranged line of credit. There may be a fee for the transfer service.

But many potential users of overdraft protection do not have a savings account and also would not qualify for a line of credit and these options are not a practical possibility. Even in the absence of such prearrangements involving a transfer from another account or a line of credit, however, the depository and customer may arrange that the depository will honor debits from a debit card or ATM that cause an overdraft up to a certain amount, provided that the customer "opts in" to the arrangement.

Most users of this service view payday loans as the closest alternative product.[48] Both overdraft protection and payday loans are attractive to consumers with impaired credit and little or no further access to credit card or other loans but who have some urgent need for cash. Overdraft protection may be especially useful for point of sale transactions as it is far more convenient to access overdraft protection than a payday loan. Melzer and Morgan have found find that in choosing between payday loans and bank overdraft protection, most consumers choose rationally, typically choosing the product that minimizes their overall costs of acquiring credit.[49]

In the situation of an overdraft that the depository covers, the fee for advancing funds for a time makes the arrangement look much like a short-term loan for a fee, but current rules make this sort of arrangement part of the deposit agreement and not a loan subject to Truth in Lending. Like payday loans and other forms of small-dollar credit noted above, overdraft protection can mitigate or obviate fees from illiquidity that can arise in other ways, including delinquency and late-payment fees on various bills and non-sufficient-funds (NSF) fees from dishonored overdrafts.

Much of the criticism of overdraft protection arises from the assessment of fees for covering shortages in deposit accounts. In recent experience, a fixed fee of around $35 for covering a debit card or ATM overdraft is common. Unlike a payday or other loan with a specific loan amount for a fixed amount of time set by contract and where an APR can be calculated and disclosed in advance, an analogous APR for a specific overdraft-coverage event can only be calculated after the fact: As with a mainstream line of credit (including credit cards), the amount and timing are unknown in advance, making impossible the calculation of an APR conceptually the same as the APR on a closed-end loan like a payday loan.

Using assumed examples and experiences recorded on actual accounts, the CFPB and others, however, have calculated post-hoc APRs for these arrangements that exceed those on common payday loans. While such calculations are easy enough to make after the fact, it seems unlikely for the reasons discussed above that such APRs are as interesting or important to users as the actual charge of $35. Even in individual cases where such charges are not fully contemplated or

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[48]See Robert L. Clarke and Todd J. Zywicki, Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau, REVIEW OF BANKING AND FINANCIAL LAW (2013-2014).

[49]Brian T. Melzer and Donald P. Morgan, Competition in a Consumer Loan Market: Payday Loans and Overdraft Credit, JOURNAL OF FINANCIAL INTERMEDIATION, (January 2015).

understood in advance, they probably are understood and remembered after the initial actual encounter. This undoubtedly helps explain recent growth of low-balance electronic alert services provided by the institutions using text messages. Nonetheless, "opt in" arrangements to overdraft protection are commonly offered by depositories and often used. That individuals and institutions have made such "opt in" arrangements is consistent with underlying neoclassical economic theory that debt use comes about from opportunities and necessities that provide net benefits to informed credit users.

Even if such overdraft-protection advances are more expensive on an APR basis than payday loans, their convenience may still make them attractive to some people for managing liquidity shortages. Such circumstances include potential returned-check situations at merchants where a fee and possible ill will could be involved, or some other sort of emergency. The convenience of prearrangement compared to a payday loan would tend to make them competitive with payday loans, even if the cost is somewhat higher than a small payday loan. Neither of these sources of small-dollar credit is available to those without a depository account (the "unbanked") who would still be restricted to credit sources like pawn lenders, specialized retail outlets, and individuals.

Rent-to-Own Programs

Before concluding this section, it is worth also mentioning rent-to-own programs. Strictly speaking, rent-to-own transactions are not credit, but they serve as credit substitutes in some cases, and critics sometimes lump them together with small-dollar credit products. Rent-to-own transactions are actually rentals of household durable goods like furniture and appliances on a week-to-week or monthly basis but with automatic renewal until stopped. They sometimes are combined with small-dollar credit products because at some point the rental provider has received enough in payment and the property has aged and depreciated enough that it does not have much remaining resale value anyway. At this point, the provider simply hands over ownership to the lessee, hence, "rent-to-own" that providers heavily advertise as a possibility.

The arrangement differs from an installment purchase of the product, however, because the provider bears the ownership risks and costs during the rental period. These include delivery, set-up, repair, loaner service, refurbishing, and eventual re-rental or sale. The renter can return the product at the end of any rental period without early termination fee or further charge, except for damages. This avoids difficulties or costs associated with resale or disposal that might occur for owners.

With survey research in 2000, Lacko, McKernan, and Hastak found in a report for the Federal Trade Commission that about two thirds of rent-to-own users intended to purchase the item and about 70 percent actually did so.[50] Leaving aside the issue of how the costs of use (delivery, set-up, extended warrantee, etc.) are not strictly comparable between rent-to-own and installment purchase, calculating an APR on a typical transaction as if it were the same as an installment purchase reveals a high APR. A high APR on a relatively small transaction is why rent-to-own becomes lumped with small-dollar lending in many discussions.[51]

Lacko, McKernan, and Hastak also reported that three quarters of the survey respondents said they were satisfied with the transaction. They did not question respondents about costs, but responses to questions about satisfaction indicated that "many respondents were aware that the price was high." Satisfied customers typically reported characteristics of the item being rented or services provided by the rent-to-own company as a reason for satisfaction. Few customers gave inadequate cost information as a reason for a poor evaluation.

Customer characteristics suggest that limited credit availability from other sources likely played a role in their decision to use rent-to-own. Available information suggests that rent-to-own users are comparable to pawn borrowers and are on average younger and lower income even than payday or auto-title borrowers and much younger and lower income than the population as a whole.[52]

Illegal Lenders

For the obvious reason that too much inquisitiveness can be dangerous to health, academic researchers have tended to stay away from studying the illegal loan-shark industry, although on occasion research reports have arisen.[53] Much of what is known about illegal lending arises instead from criminal investigations that take place from time to time.[54] The worst aspect of

[50]JAMES M. LACKO, SIGNE-MARY MCKERNAN, AND MANOJ HASTAK, SURVEY OF RENT-TO-OWN CUSTOMERS (Federal Trade Commission, 2000).

[51]Durkin, et al. (2014), *supra note 3,* provide some APR calculations on their pages 366-7.

[52]Information on rent-to own customers is not available from the sources used in Table 5-1. Somewhat earlier comparative information, including from Lacko, McKernan, and Hastak for rent-to-own, is in Durkin, et al. (2014), *supra note 3,* Table 8.3, p. 375.

[53]See John M. Seidel, *Let's Compete with Loan Sharks,* HARVARD BUSINESS REVIEW, (May-June, 1970); Ronald Goldstock and Dan T. Coenen, *Controlling the Contemporary Loanshark, The Law of Illicit Lending and the Problem of Witness Fear,*" CORNELL LAW REVIEW, (January, 1980); and David Baker and MacKenzie Breitenstein, *History Repeats Itself: Why Interest Rate Caps Pave the Way for the Return of the Loan Sharks,* BANKING LAW JOURNAL (2010).

[54]*See,* for example, NEW YORK STATE COMMISSION OF INVESTIGATIONS, *THE LOAN SHARK RACKET* (1965).

illegal lending is how criminal enterprises have been known to engage in violence as part of collection activity, although the general belief among lenders apparently has been that too much violence is counterproductive by driving away potential customers from this market. News reports suggest it still exists, however.[55] It has even invaded popular culture through the movies.[56] It seems unlikely that most individuals, even those down on their luck and without other available credit, would approach known criminal loan sharks today, but there have been many instances of doing so since at least the time of the Roman Empire.

In sum, it seems reasonable that more research findings on how individuals actually use small-dollar loans (or overdraft protection and rent-to-own) could help inform debate in the small-dollar area. Such research is expensive and uncommon, however, and even if undertaken more frequently seem destined not to settle in any sense the policy debate over small-dollar credit anyway.

For policy conclusions in the area of small-dollar loans, there still are tradeoffs to address. Economic theory and considerable empirical evidence suggests the usefulness of small-dollar loans, but not everyone agrees this is sufficient. For instance predictions by consumers of timing of full repayments of payday loans that are "exactly correctly on average" (Allcott, et al., p. 3) is a significant finding but not exactly the same as "exactly correct always." The latter is, of course, an impossible standard, given contingencies, but this is not the same as saying it is not popular or wished for.

Further, findings show that some people are uninformed or are "present focused." Also, risks unknown at the outset of a transaction sometimes can cause bad outcomes, even among the informed and rational. And small-dollar is the area of the highest cost (per loan dollar) and riskiest consumer credit. Finally, there is still also a contingent of observers who approve of wisdom perceived in Senator Proxmire's contention in 1972 in the *Report* of the National Commission on Consumer Finance: "State governments have traditionally sought to protect consumers from the consequences of their own folly by limiting rates of interest" (p. 229). It seems he has not been the only observer with this view.

[55] See, for example, 22 Held in Staten Island Betting and Loan Sharking Raids, Associated Press, November 18, 2009; Dave Warner, Authorities Accuse 13 in Philadelphia of Mob Charges, Reuters, May 13, 2011; J. Roebuck, In Court 'Frankie the Fixer' Describes Collecting Loan-Sharking Debts, McClatchey Tribune Information Services, January 2, 2014. According to news reports, loan sharking is apparently of concern in parts of Europe, Asia, and Africa.

[56] For instance in the early part of the original "Rocky" movie that won the 1976 academy award as Best Picture, the Rocky character played by Sylvester Stallone is employed as a loan shark collector/enforcer in Philadelphia. An actual convicted New York loan-sharking leader named Anthony Salerno was a main character in the 2019 movie "The Irishman."

So, findings once again highlight the conundrum for legislators and regulators in this area: How to manage the tradeoff of denying availability of products like high-rate small-dollar loans that can help many users in appropriate situations but are high cost relative to loan dollars and some kinds may be difficult to repay in a short period of time. They also can sometimes harm individuals in situations of present bias. Such situations are less useful for enhancing welfare, and there are also the cases where credit simply does not work out well because of unfortunate contingencies that develop after the loan is made in good faith by both parties.

5.4 A Normative Concern

As noted at the outset of this chapter, small-dollar lending is a distinct market with some submarkets for different kinds of small-dollar loans, but discussion here shows that its economics is not unique. What is different about small-dollar lending involves the special conditions and constraints on consumers and providers in these markets, not their fundamental economics. There have been constraints on lenders throughout history (Chapter 2 above), but there still is demand for credit based upon its usefulness (Chapter 3), and supply is still determined by its costs (Chapter 4), even where the amounts are small.

As the foregoing shows, the basic characteristics of the small-dollar lending market are consistent with the predictions of neoclassical economics of consumer finance usage. Consumers who use small-dollar loans do so for the same reasons as consumers in mainstream credit markets: to take advantage of opportunities and mitigate costs of emergencies while changing the timing of the purchases to a preferred one.

But they do so under the distinctive condition of being *rationed* in credit availability. Many of them seek such credit at the state in their life cycle when demand for credit is highest but supply is lowest causing an imbalance. As a result, rationed consumers are unable to acquire all of the credit they demand from mainstream lenders and turn to secondary (higher cost) lenders, sometimes referred to as "fringe" lenders, to meet that demand. The prediction is that many borrowers using small-dollar lenders would be younger and more credit-constrained than those who use mainstream credit. This turns out to be an accurate prediction.

As shown in Chapter 4, the underlying cost structure of small-dollar loans suggests that the costs of making small dollar loans is expensive in both absolute and relative terms per loan dollar. This is inherent in the reality of relatively-fixed production costs: the cost of making loans does not scale proportionally with the size of the loan. Thus, the costs of small amounts of credit are high per loan dollar.

This interaction of supply and demand suggests that the equilibrium price per loan dollar for small-dollar loans will also be high. Moreover, there appears to be little reason to conclude that the actual prices that we see in the market are distorted by competitive issues or insufficient consumer protection. As history confirms, it is simply not possible simultaneously to control the price of small-dollar loans and still provide a supply that meets consumer demand. This is not a market failure but rather the perennial problem of how to provide small-dollar loans to wage earners at a price below that required by the market.

This reality has been long understood. So then why do we see repeated cycles of regulation and efforts to control prices and the supply and demand of small-dollar loan products? Apparently the answer is that while many acknowledge these equilibrium conditions, they are also uncomfortable with this outcome.

For the Taskforce, this gives rise to something we characterize as our normative concern on this topic: whether society believes consumer credit availability for everyone is a good idea or not. Chapter 3 discussed the ageless economic motivations for the widespread phenomenon of consumer credit use today, how it provides the wherewithal to change spending timing and make large purchases and mitigate short-term emergencies that do not fit into family budgets. This mostly involves the kinds of purchases today that provide a return over time through vehicles, appliances, recreation and hobby items, repairs, modernization, and management of emergencies. The return comes about through acquiring the services they provide sooner than would otherwise be possible, avoiding purchasing less desirable (and often costly) substitutes in the meantime or doing without (and even "frittering away" the money). Such favorable outcomes can result from using mainstream forms of credit but also from employing less traditional smaller amounts. Nonetheless, there are difficulties here and all of this has remained a divisive area for centuries.

It seems that all observers some of the time and some observers all of the time today agree that credit availability is good for many individuals and should not be restricted from those who show evidence of ability to use it well. But some observers some or all of the time maintain that credit use is often too expensive (and possibly too dangerous) for at least some individuals. Some observers go farther still and recommend legal restrictions to protect the subset it may be dangerous for. Recently, it seems that at least some of the latter group have seized upon a developing new branch of economics referred to as "Behavioral Economics" that they believe supports this more-restrictive view. Many economists, including behavioral economists, disagree with this contention, as discussed further in the second half of Chapter 3. Instead, they contend that the motivations and evidence about using credit are much more fundamental than some behavioral biases identified by experimental researchers using student subjects in unreal settings that are not robust empirically with most consumer-credit uses.

But the Taskforce concludes that at its deepest level, whether or when to restrict credit use is not only a dispute in theoretical economics or about the worth of available empirical evidence. Evidence clearly shows that credit use is beneficial to most individuals in a wide range of situations, although undoubtedly with risks and sometimes with unfortunate outcomes. In this context it should not be surprising that studies of small-dollar credit use (in recent years, mostly concerning "payday" loans) find mixed results on questions of impact on overall consumer welfare. Sometimes these unfortunate outcomes are simply correlated with financial struggles, not the cause, as many of these products are last efforts to find a financial lifeline to stave off a descent into bankruptcy. Outcomes from credit use always vary among individuals, and probably vary most of all where small-dollar credit is involved due to the difficult financial circumstances of the users. Even mortgages, credit cards, and other mainstream financial products have risks for consumers.

Certainly, differences in outcomes are going to exist. Economic theory and widespread empirical evidence clearly shows the advantages that can result from consumer-credit use, but difficulties that can develop are also well known. They include nonpayment, lawsuits, repossessions, and unfortunate, stressful collections at the worst possible time. These sorts of difficulties with credit can sometimes be seen clearly (with hindsight) when enough repayment ability was clearly not there, but they are mostly unforeseen for individuals at the outset of a credit transaction, developing only after unfortunate later contingencies. There also may occasionally be overreaching by certain institutional providers that can give consumer credit and its other providers a bad reputation. Some people may also be shortsighted. But the crux of the dispute goes deeper and does not seem resolvable by economic theories or empirical evidence about outcomes. Rather, it depends both on how observers evaluate the underlying tradeoff between potential rewards and risks of credit use and how they interpret their relationship to those caught up in this tradeoff, especially lower-income consumers. Sometimes existence of this tradeoff results in actions by governments.

In 1972, the National Commission on Consumer Finance addressed this tradeoff and came down on the side of encouraging credit availability by relaxing legal rate ceilings on small-dollar lending and promoting competition and consumer empowerment through information instead of imposing legal caps on prices. After discussing historical sources and reviewing studies and statistics, the NCCF wrote in its *Report* (p. 136):

> The implications of these findings for public policy seem obvious: the only truly effective way of gaining ample supplies of personal loan credit for consumers *and* reasonable rates too, is to increase competition while simultaneously relaxing inordinately restrictive rate ceilings.

Not everyone agreed then (or now). Among many examples from many sources of the opposing view at the time, the opposing view is also found in the Commission's own *Report* especially in the “Separate Statement” of Commissioner and Senator William Proxmire, already quoted in part (NCCF *Report*, p. 229):

> What the Report fails to recognize is that consumers are not nearly as sovereign as economic textbook theory would have us believe. ... The real choice is not between paternalism and no paternalism as the Commission report assumes. It is between business paternalism that is largely unaccountable to the public and responsible government policies. State governments have traditionally sought to protect consumers from the consequences of their own folly by limiting rates of interest.

Thus, whether credit use for all based upon their own judgements, and particularly small-dollar credit use, becomes a normative (philosophical or value-judgement) dispute over the propriety (and effectiveness) of government action in allowing sometimes costly or risky individual behaviors in a free society. Users of small amounts of credit potentially can benefit like anyone else but there are special costs and risks involved too. Small-dollar loans produce difficult examples for society of the potential benefits-cost-risk tradeoff inherent in any credit use.

This Taskforce realizes that it can provide, review, and update evidence on questions of the value of small-dollar credit use and its costs and problems (and even how some problems might be addressed). It also can recommend more research, but it cannot satisfactorily ever answer this normative question: whether society believes that credit availability is a good idea or not, including for those who want or need small amounts and only can qualify for small amounts. The hope is that its work will be helpful in clarifying these tradeoffs and debates, at least until the next commission or taskforce must address the same unending issues once again in some future decade. The ineluctable conclusion of centuries of historical and legal analysis is that small-dollar credit can be provided to higher-risk borrowers only at high cost or not at all.

Concerns over credit use today clearly are greatest in the area of small-dollar lending. For illustration, this is the last remaining bastion of binding domestic interest rate ceilings today and the one often suggested as in need of further extension.

By its nature, small dollar lending is going to involve individuals without much money, that is, without much discretionary income or liquid assets. Such individuals are not necessarily poor, but many are poor and down on their luck. Middle- and upper-income individuals are less likely to need small-dollar financing at all and if they do occasionally for convenience they can pull out their purses and wallets with their credit cards. And so the debate is going to center on these poorer and illiquid individuals.

Another underlying problem here is that by their nature, small-dollar loans at low rates do not generate much revenue for the lender to go with its costs, as discussed in the previous chapter.

Application of the same interest rate to a smaller and smaller balance for the same length of time produces less and less revenue as the loan size shrinks. At some loan size, the revenue does not cover the costs of lending; and, in a capitalistic economy, below some breakeven loan size no (legal) lender from the private sector will make smaller loans.

One way out of the problem of credit availability for those in need of small-dollar amounts is to raise the interest rate or allow fees that amount to more interest on legal small loans. This was the approach favored by the progressive reformers of the Russell Sage Foundation in the 1910s to drive out the loan sharks. In 1972, the National Commission on Consumer Finance again explored the viability of this approach. Because it increases lending revenue and encourages legal lenders to be willing to lend, the NCCF concluded it would improve credit availability usefully.

But many people since at least Biblical times (including Senator Proxmire in 1972, as noted twice above) have objected to this approach to lending over the decades and centuries. The reasoning is that the higher interest rate on small loans is perceived as taking advantage of the poor and those down on their luck and making repayment more difficult.[57] The NCCF wrestled with this question especially in Chapters 6-8 of its *Report* and we have to do so too (Chapter 4 and the present chapter). But we are fearful that this is not solely an economic or legal analytical question and that there is no satisfactory solution or recommendation that will satisfy everyone.

Poor and illiquid individuals' needing to pay higher rates for credit than middle-income and wealthier individuals who use larger amounts of credit has been unacceptable to many members of society for a long time. The result in many times and places has been governmental institution of rate ceilings on credit (called "usury" laws since the middle ages and actually much older). The outcome of these laws, in turn, has been unavailability of legally-allowed credit to affected individuals in many times and places since antiquity, notably in recent years domestically at the smaller loan sizes that do not generate much revenue. Sometimes charitable efforts or new institutions for government lending are offered as potential solutions. Others argue that insufficiency of charity and the general inefficiency of government compared to the private sector in any likely governmental approach to solving this problem weigh against these potential solutions. Even if this question is resolved, charitable or governmental lenders still must deal with the reality of operating costs, as do other worthy public ventures ranging from education to national parks.

[57] The cost of making small loans to consumers is discussed in Chapter 4. Since small loans typically are also of short maturity, they may actually not be as costly in dollars as larger loans made at lower rates, but they certainly can appear more costly on a rate basis, as also discussed in Chapter 4.

Credit for everyone and especially for individuals with limited current resources involves the questions how significant is household credit use in the economy and why households might want to use credit in the first place (Chapters 2 and 3 of this report). Clearly it also involves costs of credit availability and how rationing can develop (Chapters 4 and 5). It also involves proper disclosures and competition (Chapters 7 and 8). But, as indicated, this discussion raises difficult questions that go beyond economics, law, and the institutions of lending that are the subjects of this Taskforce's efforts in any of these chapters. We note two components that society must resolve to answer the normative concern whether credit should be available for all and especially for those with limited means who need small amounts:

> 1. Is it proper for the government to decide who can obtain credit or not when there is a range of potential outcomes from good to bad, a subpart of the question what is the proper role of government in a free society? Although beyond the scope of any Commission or Taskforce on financial regulatory laws, this question naturally constantly impinges upon this Taskforce's efforts.
>
> 2. How can society solve the problem of poverty that raises most of the small-dollar lending concerns in the first place? This seems to be an even more serious and difficult question that has vexed human history since its beginning.

The National Commission on Consumer Finance was not oblivious to these concerns either and discussed them at some length in a mostly overlooked part of its *Report*. It is worth quoting at some length from this passage now (in its somewhat archaic original rendition) since this Taskforce recognizes the same issue (NCCF *Report*, Chapter 1, p. 2):

> As Congress recognized, such an appraisal must begin (and end) with the issue of whether the industry provides adequate consumer credit to those who want it at reasonable rates. *Unfortunately, the Commission has been able to devise no empirical method for determining who should get credit, how much credit, what kind of credit, and at what price* [emphasis added].
>
> It is questionable whether legislators want to begin making the intricate social judgements involved in designing laws to spell out who should get credit, how much, and at what rate. Most legislators attempt at all times to represent the best interests of their constituents. But their expertise is in the field of laws and statutes, not in rulemaking and regulations required to specify what part of a family's income could safely be devoted to monthly payments on credit obligations – given such variables as size of family, age of wage earners, nature of employment, and so on. This is the kind of activity the industry itself is constantly working on and attempting to improve by means of its credit scoring systems. The profit motive should be strong enough in our economy to assure that credit grantors will try to make as

much credit available at "fair" prices and that if one creditor's "blind spot" keeps him from extending credit to a creditworthy individual, another creditor will probably jump at the chance.

This does not mean that there is no role for the legislator in the area of consumer credit. There are critical functions – namely: (1) to promote and assure the maintenance of what the Commission deems to be the key ingredient of a finance industry capable of providing an adequate supply of credit at reasonable rates – competition among numerous alternative sources of credit; (2) to assure access *by all* [emphasis in original] to those alternative sources of credit; and (3) to prevent excesses which the system may provoke against the borrower.

Not specifically mentioned by the Commission, but certainly present in its overall tone, is the recognition that not everyone is going to agree with the worth of outcomes that the market system provides by itself in individual situations subject to risk. This Taskforce can agree, or not, with the findings and wisdom of the Russell Sage Foundation or the earlier Commission, but no financial study group can empirically satisfy remaining disagreements about the role of government in society and the solution to the problems of poverty. Neither, it seems, can it design legislative recommendations in these financial areas that satisfy all observers all of the time.

5.5 Conclusion: Insolubility of the Concern

And so, what is the answer? In the previous section we raised the question ultimately, whether society believes that consumer credit availability for everyone is a good idea or not. Since the beginning of recorded history and probably much longer, individuals have faced situations where more current resources would be useful, particularly in early life-cycle stages where demand for assets is high and available resources often low. Theory and evidence shows there are benefits to using credit in mainstream situations. These occur when acquiring assets that provide a positive return over time in the form of housing, transportation, education and better employment prospects, preferred recreational possibilities such as with boats and motor homes, and periodic mitigation of emergencies. Some credit use may indicate recklessness and impatience, but evidence suggests this aspect of credit use is less important than sometimes believed. All credit use is subject to risks of variable outcomes, including unfortunate ones not foreseeable in advance.

Some borrowers face additional difficulties due to lower or more variable incomes, more credit already outstanding relative to ability to repay, limited liquid assets, and underlying greater risks. Often such individuals are rationed, in that they are unable to obtain as much credit as they would otherwise prefer at the lending rates of primary (low-rate) lenders. Thus, they face the additional problem of needing small amounts of credit that operating costs and risks make more expensive on a rate basis.

This leaves stark tradeoffs in the marketplace and also among policy makers. Most observers believe today that availability of mainstream consumer credit is worth the risks that it entails, but the policy tradeoff problem is greatest where small dollars of credit are involved. There is little doubt that such lending is more costly per loan dollar than mainstream consumer credit.

All this then raises the issue of the role of government in society where these tradeoffs are concerned. Should government in a free society allow small-dollar loans or prevent them? Specifically, how can markets satisfy everyone that small-dollar credit is properly available to those who need it while not charging them more per credit dollar for the costs and risks involved? More generally, how can their needs for small amounts of credit be eliminated? Ultimately, such needs are poverty-based. History shows that no government favors poverty and also that none has been able to eliminate it, regardless of political choices or system. And so, the question of the proper role of government on more-limited issues like small-dollar lending remains unsettled.

The Russel Sage Foundation and the National Commission on Consumer Finance proposed possible answers in this area (actually the same answer). Both were controversial in their times. There is no gain for this Taskforce to propose the same, or any other, solution to this question and to proclaim it now as the Big Answer, although it should be reexamined and we think the discussion here can help.

There always are, and always going to be, tradeoffs of potential gains and losses to be considered concerning credit use by individuals, the ongoing conundrum for legislators and regulators in this area. It seems, unfortunately, that any proposal or potential answer is going to be controversial in the same old ways, like any difficult question. The Taskforce urges more rational and fact-based discussion. And, like the National Commission on Consumer Finance before it, this Taskforce recommends and urges further research and discussion of facts to characterize the debate. This would be much more useful than merely further recycling of the tired old arguments and slogans of the past (like knee-jerk characterizing all small-dollar lending as either "beneficial" or "predatory" without reviewing and understanding the facts). Complaints and arguments have ranged from religious prohibitions to value-judgement musings, some of them now well into at least the fourth millennium of their time. Now is the time for something new, like reasonable discussion of tradeoffs and the possibility of reasonable compromise on an important policy question.

6. Consumer financial protection principles

The National Commission on Consumer Finance (NCCF) identified four overarching principles for a well-functioning, efficient, and fair consumer credit system: (1) to protect consumers from "excesses" by financial services providers, (2) to empower consumers by providing them with information to shop more effectively for the products they desire and to facilitate competition, (3) to instill competition as "the key ingredient of a finance industry capable of providing an adequate supply of credit at reasonable rates," and (4) to promote access for all consumers to quality financial services.[1] These four basic orienting principles—consumer protection, information, competition, and inclusion—remain equally valid today as they did fifty years ago.

Part II of the Taskforce Report examines the core principles of consumer financial protection, starting in this chapter with consumer protection principles. Analysis of information provision as consumer protection through disclosures of terms and other means will be the focus of Chapter 7 of this Report. Competition will be the focus of Chapter 8. Chapter 9 focuses on innovation, which cuts across competition, inclusion, information, and consumer protection. Inclusion and access will be the focus of Chapter 10.

This chapter focuses on the question of consumer protection. It is a propitious time to review the consumer protection regime with respect to financial services. In the fifty years since the NCCF Report, there have been profound changes to the federal consumer financial protection ecosystem. From the modest beginnings with the Truth in Lending Act (TILA) in the late 1960s, numerous laws and regulations have been layered atop each other. Interstate branch banking has been legalized, and credit card interest rates and other price terms have largely been deregulated. At the time of the NCCF Report, general purpose credit cards were a relatively new product, and the consumer finance economy was becoming increasingly national in scope and operation; today, consumer payments, lending, and other transactions are increasingly conducted over the

[1] Report of The National Commission on Consumer Finance, Consumer Credit in the United States 2 (Dec. 1972).

internet. Technological innovation has created both new opportunities for consumer benefits but also potential new dangers, a trend that was accelerated by the COVID-19 pandemic. Banking crises in the 1980s and 2000s, both rooted in residential mortgage markets, spawned large-scale regulatory reforms. And in 2008 the world experienced a financial meltdown related to residential mortgages that raised calls for new regulations and new regulatory institutions. 2020 marked the tenth anniversary of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that established the Consumer Financial Protection Bureau (CFPB or Bureau).

This chapter focuses on several elements of the consumer protection question. First, it briefly reviews the history of consumer financial protection legislation and regulation in the United States, with a particular focus on the growing role of the federal government in consumer financial protection over time. Second, it identifies the fundamental objectives of a well-functioning consumer financial protection regime and the institutional framework for its implementation. Third, this chapter examines the criteria for intervention by regulatory agencies, with special focus on the CFPB. Finally, this chapter examines the CFPB's regulatory tools to analyze the particular roles that each of those tools can and should play and how to use those tools in a coordinated fashion to construct an optimal consumer financial protection regulatory regime.

6.1 Historical Background: State and Federal Regulation

In the United States, consumer financial protection historically was governed primarily at the state level. Moreover, the traditional approach to consumer financial protection was largely in the nature of *substantive* regulations, meaning direct regulation of the products that are offered, including regulation of interest rates, loan sizes, and other product features. The primary method of regulation at the state level was the establishment of maximum interest rate ceilings, known historically as "usury" regulations, as well as other substantive regulation of terms and conditions of financial products, such as maximum loan sizes and restrictions on competition and new entry.[2]

[2] Usury regulations and their impact on consumers are discussed in greater detail in chapters 5 and 10.

As a historic matter, the federal government had a minimal direct role in consumer financial protection for most consumers and most products for most of American history. The federal role was not nonexistent, but its consumer protection function was largely a byproduct of its supervisory authority over federally chartered depository institutions and savings and loans. Where the federal government used substantive controls on consumer financial products such as maximum interest rates on savings accounts, it was usually to promote certain economic or other policy goals, such as controlling interest rates, initially to subsidize wartime financing during World War II, but then continuing interest rate controls after the war to promote the housing market, and still later as a complement to monetary policy efforts to control inflation. The Federal Trade Commission (FTC) also enforced federal law against unfair and deceptive acts and practices involving consumer financial services. The federal government's role in consumer financial protection expanded beginning in the 1960s and has grown dramatically since that time.[3]

Government regulation of consumer financial products and services is as old as credit itself.[4] The primary focus of consumer credit regulations was the imposition of price ceilings on the interest rate that could be charged on loans, historically known as "usury" ceilings. Many states also imposed limitations on the remedies available to creditors in the event of the debtor's default.[5] For example, many states abolished imprisonment for debt during the first half of the 19th century. Often the two elements would go together, as stricter interest rate ceilings often were associated with more lenient regulation of remedies that were available to creditors upon default.

Economists have long been critical of usury ceilings, dating at least to Jeremy Bentham's famous tract, *In Defense of Usury*.[6] By the time of the NCCF, the expert consensus was that despite the historic ubiquity of usury ceilings and other substantive regulations through history, the costs of those restrictions substantially exceeded the benefits for consumers and the economy.[7] Moreover,

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[3] An extensive discussion of the history of state and federal regulation is available in Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd Zywicki, Consumer Credit and the American Economy (2014), especially chapters 10 and 11.

[4] For example, the Code of Hammurabi (1750 BC) included limits on the interest rate that could be charged on loans. *See* Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, Consumer Credit and the American Economy 483 (2014).

[5] For example, in addition to limiting interest rates, the Code of Hammurabi also placed limits on creditor's remedies. Many traditional remedies were barbaric compared to what are currently known as remedies for default. *Id.* at 484.

[6] *See, e.g.,* Jeremy Bentham, In Defense of Usury (1818).

[7] The underlying economic analysis of usury regulations is discussed in detail in chapters 5 and 10 of this Report. The brief discussion here is designed to illuminate the intellectual context that shaped the NCCF's deliberations and research efforts.

it was recognized that those costs fell most heavily on lower-income and higher-risk consumers, who were forced to pay higher prices for the goods that they purchased, had access to less competitive credit markets, and in at least some instances, were forced into the hands of illegal loan sharks. Paul Samuelson, the first American to be awarded the Nobel Prize in Economics, testified before the Massachusetts State Legislature in 1969 in arguing for the elimination of usury ceilings on consumer credit:

The concern for the consumer and for the less affluent is well taken. But often it has been expressed in a form that has done the consumer more harm than good. For fifty years the Russell Sage Foundation and others have demonstrated that setting too low ceilings on small loan interest rates will result in drying up legitimate funds to the poor who need it most and will send them into the hands of the illegal loan sharks. History is replete with cases where loan sharks have lobbied in legislatures for unrealistic minimum rates, knowing that such meaningless ceilings would permit them to charge much higher rates.[8]

And fellow Nobel Laureate economist Milton Friedman similarly observed in 1970, "I know of no economist of any standing from [Bentham's] time to this who has favored a legal limit on the rate of interest that borrowers could pay or lenders receive ..."[9]

As underlying interest rates rose and inflation soared during the 1970s, the distortionary effects and economic and social harm created by usury ceilings became increasingly apparent. As a result, expert opinion turned sharply against the wisdom of traditional usury ceilings and other substantive command-and-control style regulations as a mechanism for consumer financial protection, favoring instead disclosure-based approaches.

6.1.1 The Evolution of Federal Regulation

At the same time that evolving economic trends were exposing the costs of substantive regulation, the post-war American economy was becoming increasingly national in scope, fueled by falling transportation and communication costs. As discussed in Chapter 3, the post-war prosperity and great migration of Americans to the suburbs in the post-war era fueled an explosion of demand for automobiles, furniture, appliances, and other consumer durables, which

[8] Statement by Dr. Paul A. Samuelson Before the Committee of the Judiciary Of the General Court of Massachusetts in Support of the Uniform Consumer Credit Code, *reprinted in* Statements of Former Senator Paul Douglas and Professor Paul Samuelson on the Uniform Consumer Credit Code 7, 8 (National Conference of Commissioners on Uniform State Laws, Jan. 29, 1969).

[9] Milton Friedman, *In Defense of Usury*, Newsweek (Apr. 6, 1970).

in turn fueled a rapid increase in demand for consumer credit. The American population grew and became more mobile. Interstate migration and technological improvements that enabled financial products to be offered across state lines more easily (such as declining long-distance telephone rates) also made the consumer finance market more national in scope. Regional and national department store chains grew, with retail operations in multiple states.[10] As those regional and national chains grew, merging with or eliminating smaller rivals, those chains centralized their credit operations in their headquarters while operating under the rules of multiple states.[11]

In the decades following World War II, banks were limited by branching restrictions from expanding beyond their home state. Beginning in the 1950s and expanding into the 1960s, however, bank-issued credit card became more widespread, conducting their operations primarily through the mail and telephone, not through a traditional bank branch network.

The growth of national consumer finance markets created increasing pressures for a greater federal presence in consumer financial protection law. An example is provided by the regulation of debt collection operations. Unfair and abusive debt collection practices traditionally were regulated at the state and local level as many of the major consumer protection concerns dealt with in-person harassment and similar activities by creditors. As the price of long-distance telephone calls fell through the 1960s, however, debt collectors increasingly operated across state lines, rendering local regulation and enforcement increasingly ineffective and cumbersome.[12] National credit reporting agencies evolved to meet the needs of this growing national market and

[10] Some department store chains, most notably Sears and Roebuck, already had national footprints but interstate department store chains were anomalous in the pre-War era. Large chains accounted for less than 15 percent of department store sales in 1929 but nearly 80 percent of department store sales by 1972. *See* Robert M. Hunt, *Development and Regulations of Consumer Credit Reporting in the United States*, *in* The Economics of Consumer Credit 301, 310 (Guiseppe Bertola, Richard Disney, and Charles Grant eds., 2006).

[11] Today a similar wave of is overtaking retailing that has accelerated these trends. By the First Quarter of 2020, over 11 percent of retails sales were made online, a figure that jumped to over 16 percent in the Second Quarter as retail stores were shuttered as a result of government responses in many states to the viral pandemic at the time. *See E-Commerce Retail Sales as a Percent of Total Sales*, Fed. Res. Bank of St. Louis Economic Research, *available in* https://fred.stlouisfed.org/series/ECOMPCTSA. Regulations in many states that permitted vendors of "essential" consumer goods to remain open while other retailers were forcibly closed also accelerated the trend toward a greater share of bricks-and-mortar retail being provided by large interstate "big box" retailers that sold those items as well others. *See* The Real Deal, *A Few Big-Box Stores Now Account for 29% of US Sales*, TheRealDeal.com (Aug. 25, 2020), *available in* https://therealdeal.com/2020/08/25/a-few-big-box-stores-now-account-for-29-of-us-sales/.

[12] See Todd J. Zywicki, The Law and Economics of Debt Collection and Its Regulation, 28 Loyola Consumer L. J. 167 (2016).

the decline in localized personal banking relationships, raising additional novel consumer protection issues regarding consumer privacy and information.[13]

The interstate nature of these developments challenged traditional state-based jurisdictional boundaries, giving rise to increasing calls for a larger federal role in consumer financial protection. But at the same time, the growing consensus on the baleful effects of usury and similar regulations on consumers and the economy generated calls for a "fundamentally new approach" to consumer financial protection focused on "extensive required disclosures to consumer[s] of transaction-specific information" in place of substantive controls on product design and terms.[14] To be sure, many states also had disclosure laws of one form of another that supplemented substantive rules.[15] "Before that time," however, "consumer protection in the credit area had been state responsibility, and states had been interested primarily in establishing and enforcing credit price ceilings within their boundaries (usury laws) and in licensing the providers of credit and circumscribing certain practices considered objectionable."[16]

As crystallized in the NCCF's Report, which represented the consensus view at the time, the organizing principles of the modern consumer credit regulatory system was founded on the principle of robust competition and consumer choice as the first goal of consumer financial protection, and the primary focus of regulation should be to make markets work better for consumers by increasing transparency, competition, and consumer choice. The enactment of the TILA in 1968 marked the beginning of a new era of disclosure-based regulation that focuses on providing consumers with relevant information that will enable them to make better decisions and promote robust competition and consumer choice. Several similar regulations followed later, such as the Truth in Leasing Act in 1976 (implemented by Regulation M) and Truth in Savings Act in 1991 (with Regulation DD). A defining characteristic of new federal regulation was growing skepticism of substantive controls on terms and product design, such as price controls on interest rates and other terms and conditions of consumer financial products. In addition, new substantive legislation and regulation was enacted where there was a perception that markets failed to work fairly and efficiently, and information-based and existing state regulation were inadequate to address those problems. This second category included areas such as discrimination (the Equal Credit Opportunity Act and Fair Housing Act), where it was perceived

[13] *See* Hunt, *supra* note 10; *see also* chapter 11 of this Report.

[14] Durkin, et al., Consumer Credit, *supra* note 3, at 453.

[15] *See* NCCF Report, *supra* note 1, at 170-71 (discussing state predecessors).

[16] Durkin, et al., Consumer Credit, *supra* note 3, at 453.

that market processes had failed to adequately eliminate discriminatory practices, and various regulations on credit reporting (the Fair Credit Reporting Act), debt collection (Fair Debt Collection Practices Act (FDCPA)), and other markets where market incentives and constraints were not fully aligned to promote consumer welfare through competition and thus information-based remedies would be inadequate to fully remediate and prevent harms. Many of these substantive regulations also had disclosure remedies attached to them designed to enable consumers to also take steps to protect themselves.

As the NCCF observed, the logic of usury ceilings and other substantive regulation of terms and conditions of financial products fundamentally rests on the idea that politicians can determine better than the free interaction of consumers and financial service providers operating in competitive markets "who should get credit, how much credit, what kind of credit, and at what price."[17] The Commission concluded that it could "devise no empirical method"[18] for answering those questions any more than it could establish whether the "price of a hamburger or shoes was 'fair' at any given time, or that more of either might be better."[19] To answer those questions throughout the rest of the economy:

[W]e look toward a marketplace. If sufficient alternative sources compete for patronage, it is assumed that the price and supply are 'fair', because they are set by free competitive forces. The Commission perceives no reason to assume that—in general—competition will not have the same result in the consumer credit area.[20]

The NCCF's criticism of traditional state regulatory approaches was severe and unflinching, noting that state legislation "tended to restrain competition and unnecessarily segment the consumer credit market" and noting numerous examples such as "unrealistic rate structures" and limits on the products that particular types of entities could offer to consumers.

Instead, the NCCF identified three legitimate functions for regulation in the field of consumer credit:

> (1) to promote and assure the maintenance of what the Commission deems to be the key ingredient of a finance industry capable of providing an adequate supply of credit at

[17] NCCF Report, *supra* note 1, at 2.

[18] Id.

[19] *Id.* at 3.

[20] *Id.* at 3

> reasonable rates—competition among numerous alternate sources of credit; (2) to assure access *by all* to these alternate sources of credit; and (3) to prevent excesses which the "system" may invoke against the borrower.[21]

Moreover, "to assure that competition is meaningful," the NCCF endorsed a fourth goal of empowering consumers through providing information that could be used to promote competition and shop among different products and providers.

Finally, the Commission singled out for special criticism the deleterious effects of traditional state price-control laws on access by low-income consumers and others to competitive financial markets:

> The foregoing then, constitutes the Commission's overall recommended legislative and regulatory approach; removal of impediments and barriers, manmade and statemade, to the operation of competitive forces, proposals to assist vigilant legislatures and regulators to combat monopoly and restrictive practices, elimination of market excesses, and continued efforts to assure that the consumer will have full knowledge of his credit transactions, thereby permitting rates to be set by workable competition in the marketplace.[22]

These four principles: (1) Competition, (2) Inclusion, (3) Consumer Protection, and (4) Information remain the fundamental organizing principles of the US consumer financial protection system.

The world around consumer finance has changed dramatically in the past fifty years. Nevertheless, the current Taskforce enthusiastically endorses and recognizes the continued centrality of these four goals as the foundation of a well-functioning consumer financial protection system. To this list the Taskforce adds a fifth goal—the need to maintain an adaptable and flexible institutional framework that will enable the consumer financial protection regulatory regime to adapt more swiftly and effectively to changes in the consumer finance landscape[23]. Indeed, Part II of this Report comprising Chapters 6-10, will follow this analytical structure. This chapter discusses principles of consumer protection to protect consumers from "market excesses" and other market failures. Chapter 7 will focus on the importance and limits of information and disclosure-based approaches for making markets work more effectively, and lessons learned from the experience with disclosure regulation since the enactment of TILA.

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[21] NCCF Report, *supra* note 1, at 2.

[22] Id.

[23] This will be discussed in chapter 13.

Chapter 8 will turn to the competitive landscape of consumer financial services, and as with the NCCF Report, focuses on proposals for making competition work better and clearing away existing barriers to competition. Chapter 9 examines the particular role of innovation in promoting competition, consumer choice, and inclusion. Chapter 10 will turn to the principle of access and inclusion. Later, in Chapter 13 will provide an overview of the consumer financial protection institutional landscape and ideas for reform and modernization designed to improve its flexibility and adaptability to rapidly changing circumstances in the digital age.

The first major foray of the federal government into the realm of consumer financial protection approximately fifty years ago was driven by the growing difficulties associated with the traditional system of substantive regulation of terms and conditions of credit and the growing difficulties confronting state regulators in an increasingly national consumer finance economy. Today that problem has grown multifold as a result of the internet—not only is the economy national in scope, it is global. Even federal jurisdiction finds itself challenged to keep up with increasingly novel products and delivery mechanisms of the modern financial system. But while these innovations provide great promise for consumers, they also potentially raise new concerns, or in some instances, perceived concerns.

What should be the role and function of consumer financial protection in the 21st century?

6.1.2 Dodd-Frank, the CFPB, and the Principles of a Modern Federal Consumer Financial Protection System

The 2008 financial crisis and the legislative and regulatory response upended the traditional federal-state relationship as well as the traditional federal focus on disclosure regulation as opposed to substantive rules. The Dodd-Frank Act enacted in the wake of the financial crisis, included among its provisions several new substantive rules and regulations governing consumer financial products and services. More far-reaching, however, the Act created the new Bureau of Consumer Financial Protection (which has generally come to be known as the Consumer Financial Protection Bureau or "CFPB"), based in the Federal Reserve. The mandate of the CFPB is broad and overlaps many areas of traditional state jurisdiction as well as several other federal regulatory bodies. Equally important, it is clear that the mandate of the CFPB provides it with both the mission and resources to enlarge the federal government's role in consumer financial protection.

The idea of a federal consumer financial protection agency was not a new one. Indeed, among the NCCF's recommendations was the creation of a new federal Consumer Protection Agency (CPA) that would replace the FTC as the primary federal consumer financial protection regulatory agency for all consumer protection issues among which would be a Bureau of Consumer Credit

(BCC).[24] Failing the creation of a new larger consumer protection agency with a dedicated consumer credit bureau, the NCCF recommended the creation of a stand-alone consumer financial protection agency. According to the NCCF, the BCC, whether as a stand-alone entity or part of a larger agency, would be charged with the promulgation and enforcement of consumer protection laws, but also to monitor and promote competition and inclusion for the benefit of consumers.[25]

The NCCF also called for the federal government to take the lead in modernizing state laws that interfered with competition and consumer access. To further the goals of promoting consumer protection, competition, and financial inclusion, the NCCF recommended that if the states would not willingly remove usury restrictions and barriers to competition that harmed consumers and interfered with financial inclusion, federal action should be considered to preempt those laws. The Report states:

> Finally, the Commission fails to see why every citizen of the United States is not entitled to qualify for participation in some part of the credit system herein advocated. It can find no validity in the proposition that when the legislature of a particular state refuses to move away from anachronistic notions, its citizens should suffer deprivation of credit afforded others of equal standing. Accordingly, the commission urges as its first choice the adoption of state laws deigned both to assure fair treatment of all consumers and to give all credit grantors equal opportunity to compete. Failing this, the Commission's second choice is to urge Federal legislation to accomplish this goal.[26]

In addition, the NCCF stated, "If barriers to competition in the consumer credit market are not eliminated, federally chartered finance companies should be established utilizing the BCC as the chartering and supervisory agency."[27] Among the benefits of the federal charter identified by the NCCF was the ability to override archaic state usury ceilings and state "convenience and advantage" laws that erected barriers to entry against new competitors. Despite the NCCF's hope that states would phase out their usury laws on their own, state laws remain a patchwork of rules and exceptions and many states retain usury laws for many consumer financial products.[28]

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[24] *See* NCCF Report, *supra* note 1, at 58.

[25] *See id.* at 59.

[26] *Id.* at 4.

[27] *Id.* at 59.

[28] It is difficult to find a general summation of usury regulations. For one recent effort to collect and summarize state usury laws for small dollar loans in a simplified format, *see*

Thus, the idea of a federal regulatory body charged with a consumer financial protection mission was put forward long before the Bureau was created in the wake of the 2008 financial crisis. Notably, the NCCF's first choice was the creation of a general federal consumer financial protection agency that contained a bureau of consumer credit within it.[29] Like the NCCF's proposed agency, the CFPB is charged with a multi-pronged mission of protecting consumers from improper practices and discrimination, developing rules for the provision of information to facilitate shopping, modernizing the regulatory framework, promoting conditions for innovation and competition, and facilitating access to financial services:[30]

> b. OBJECTIVES.—The Bureau is authorized to exercise its authorities under Federal consumer financial law for the purposes of ensuring that, with respect to consumer financial products and services—
>
> 1. consumers are provided with timely and understandable information to make responsible decisions about financial transactions;
> 2. consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination;
> 3. outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens;
> 4. Federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and
> 5. markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

Despite all of these goals being part of the Dodd-Frank Act's mandate for the CFPB, it is not clear to the Taskforce that the Bureau consistently has dedicated the same degree of energy and attention toward facilitating inclusion, competition, and innovation, as it has to protecting consumers from improper practices. Several of the Taskforce's recommendations focus on the ways in which Congress, the CFPB, and other regulatory agencies can act to promote those goals.

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https://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/FactSheet-StateRateCap.pdf.; *see also* https://www.cuna.org/uploadedFiles/Advocacy/Priorities/State_Government_Affairs/a-z_usury_lawguide.pdf (more extensive treatment of state usury laws).

[29] This resembles proposals that would have done what Congress did with the creation of the CFPB, namely to collect all consumer financial protection authority within one federal agency, but not to create an agency dedicated to *just* consumer financial protection but for consumer protection more generally. *See, e.g.*, Alden F. Abbott and Todd J. Zywicki, *How Congress Should Protect Consumers' Finances*, *in* Prosperity Unleashed: Smarter Financial Regulation 287 (2017).

[30] 12 U.S.C. §5511(b).

Although the concept of collecting the federal government's consumer financial protection mission in one regulatory body is not new, the scope of authority and resources dedicated to the CFPB are. The CFPB's rulemaking authority is far broader than held by prior federal consumer protection agencies such as the FTC. In the period since its creation, the CFPB has taken its charge to engage in substantive regulation aggressively. Some of these rulemaking and actions were mandated by Congress in the Dodd-Frank Act, such as the requirement that the CFPB issue new rules governing "Qualified Mortgages" and a consumer's "Ability-to-Repay" mortgages as well as defining "larger participants" for several markets. Other rulemakings, by contrast, were discretionary, such as additional larger participant rules, rules that provided new substantive underwriting regulations on small-dollar loans, a ban on class action waivers in contractual arbitration agreements (later rescinded by a Congressional Review Act resolution), a rule on prepaid cards and updated regulations on debt collection practices, to name a few. Regardless of whether the rulemakings were required or discretionary, however, the end result has been a significant increase in substantive regulation activity by the federal government.

The Dodd-Frank Act and the CFPB also added new regulatory tools to the federal regulatory apparatus. Enforcement of federal consumer financial protection laws had always been present, mostly through the FTC and Department of Justice. Prudential regulators examined regulated entities for compliance with consumer protection laws and could issue penalties for violations. But enforcement, supervision, and regulation were patchwork affairs and often led to inconsistency and incoherence in consumer financial protection law.[31] Moreover, many products, services, and providers were regulated primarily at the state level with only sporadic and *ad hoc* intervention by federal regulators. This led to incoherent and inconsistent regulation of products that undermined competition by treating differently products that consumers view as close substitutes for one another.[32] The Dodd-Frank Act empowered the CFPB with broad enforcement resources and broad authority to enforce not only most enumerated federal consumer financial protection laws, but also expansive authority to prohibit any practices that are unfair, deceptive, or "abusive." Although the terms "unfair" and "deceptive" have developed longstanding and

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[31] *See* Todd J. Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?*, 81 Geo. Wash. L. Rev. 856 (2013) (explaining the need for increasing coherence of federal consumer financial protection regulatory regime and the supporting concept of uniting federal authorities in one regulatory authority).

[32] For example, payday loans and bank overdraft protection are close substitutes for many credit-rationed consumers. Yet payday loans historically have been regulated by states under a licensing and enforcement model whereas overdraft protection has been regulated by the federal government largely under a supervision model. Thus, although consumer welfare would be maximized by treating payday lending and overdraft protection as part of a shared product space for purposes of consumer choice, policies between the two have largely been disjointed and uncoordinated. *See* Robert L. Clarke and Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 Rev. of Banking and Fin. Law. 235 (2013-2014).

somewhat determinate meaning over decades of usage at the FTC, the term "abusive" seems to be a wholly novel term with no clear predicate meaning in prior law.[33]

To this enhanced enforcement power, the CFPB was also given authority to engage in supervision of entities that meet certain definitional classifications and asset thresholds in the law. Although many states had differing degrees of inspection and examination of state-chartered institutions, the acquisition of extensive supervisory authority for the specific purpose of enforcing consumer protection laws appears to be novel within the consumer protection regulatory sphere in the United States. Supervision is today the largest single division of the CFPB, and the Bureau exercises supervision not only of traditional depository institutions (where it shares authority for larger institutions with prudential regulators) but also small-dollar lenders and other "larger participants" in most other areas of the consumer financial ecosystem, including debt collectors and others. Finally, the CFPB also has other tools and powers designed to protect consumers, including an active office of consumer education, a public-facing consumer complaint database, and an office of research staffed largely by economists.

Thus, the creation of the CFPB marks a sharp break with the past in terms of the substantive role of the federal government with respect to consumer financial protection as well as the resources and powers to implement them. Moreover, the CFPB possesses a range of "tools" that previously were nonexistent, limited, or spread out among different consumer protection agencies in the federal government. These tools include: (1) Enforcement, (2) Supervision, (3) Rulemaking, (4) Education, and (5) Research.[34]

This chapter analyzes the principles of effective consumer protection regulation with a focus on the application of those principles to the consumer financial protection realm. The remainder of the chapter focuses first on defining the objectives of consumer protection, including the dynamics of market failure in consumer financial protection. Next, it examines the institutions of consumer protection. Finally, the chapter considers the various tools that the CFPB possesses with respect to consumer financial protection and the strengths and weaknesses of those various tools.

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[33] The CFPB held a symposium in 2019 to consider the definition of the term "abusive" and later issued a policy statement in fall 2019 that provides a definition of the term. To date, the policy statement has not yet been invoked in any enforcement or rulemaking action and it is unclear to what extent the CFPB will follow it.

[34] *See* 12 U.S.C. §5511(c).

6.2 Consumer Financial Protection Objectives

Assessing consumer financial protection requires consideration of two objectives. First, consumer financial protection is not an end in itself, but should be recognized as one component of a larger consumer welfare analysis. Consumers benefit not only from consumer protection narrowly understood, but also from greater choice, innovation, and competition that drives higher quality and lower prices. Second, to the extent that consumer protection efforts are inefficiently designed and implemented, they can have the unintended consequences of reducing access, deterring innovation and competition, and raising prices. But even more, poorly tailored regulation can actually result in *greater* harm to consumers by creating market power for some providers or by depriving vulnerable consumers of useful products that can force them to turn to inferior products and providers. Therefore, the scope of consumer protection must be properly defined as well as the particular harms to consumers that consumer protection law seeks to remedy, such that the benefits of consumer protection interventions actually aid consumers and make them better off.

6.2.1 Consumer Financial Protection Goals

As noted by the NCCF and as codified in the Dodd-Frank Act, sound consumer financial policy should be organized around four elements: (1) competition; (2) access and inclusion; (3) provision of information to consumers to help them make reasonably informed decisions and promote competition in the marketplace; and (4) "elimination of market excesses," the traditional realm of consumer protection. Elements (1)-(3) are the subject of upcoming chapters in this Report; this chapter focuses on the final element, "elimination of market excesses," which can be understood as protecting consumers from harm from fraudulent and unfair practices.

Consumers benefit from both heightened consumer protections but also benefits of greater competition: lower prices, higher quality, and greater innovation. Efficient consumer protection rules, as described below, need not necessarily entail a tradeoff between consumer protection goals on one hand and competition on the other. But at least in some cases, consumer protection law can raise costs and create barriers to entry to new competition. In carrying out their mission, therefore, consumer protection regulators should take care to avoid making their regulations broader or more ambiguous than necessary to protect consumers if doing so will also reduce consumer welfare by unduly restricting competition or increasing costs.[35] This concern about the optimal specificity of regulation is analogous to the well-known tradeoff in antitrust law between Type-I and Type-II errors, namely the difficulty of protecting the public from anticompetitive behavior while also being careful not to prohibit pro-competitive behavior.[36] Although broad and vague rules provide regulators with more flexibility to prevent harm to consumers, doing so provides incentives for providers of financial products to eschew offering new products or serving potential customers that could bring with them heightened risk of regulatory action.

Consumer welfare is maximized when informed consumers can find the financial products and services they need in a competitive marketplace. Under these circumstances, voluntary transactions are beneficial to consumers, providers of financial services, and the national economy. In addition, a well-functioning consumer financial system is crucial to the overall national economy; approximately 70 percent of American economic activity is related to consumer spending, and much of that economic activity is enabled by financial access to bank accounts, credit cards, and other consumer financial products. As painfully learned during the 2008 financial crisis and subsequent Great Recession, a breakdown in the consumer financial system can have dramatic adverse effects on the overall economy. By equal measure, the resilience of the nation's retail economy in response to the COVID-19 pandemic was possible only because of the ability of the free market to adapt to a rapid transition to online and non-face-to-face transactions and the rapid abandonment of cash transactions. Fraudulent, deceptive, and unfair practices interfere with this benevolent process, however, by enabling fraudulent providers to lure consumers into transactions that leave them worse off and enable crooked providers to lure business away from legitimate competitors. Rules that prohibit fraud, deception, and unfair practices, therefore, improve market efficiency, consumer welfare, and the competitive process.[37] Moreover, absent assurances that they will not be taken advantage of by overreaching financial services providers, consumers will be reluctant to use financial products, thereby foregoing the benefits from doing so.

This dynamic can be illustrated by the example of debt collection practices and their regulation, which also happened to be a primary concern of the NCCF with respect to consumer protection.[38]

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[35] *See* Zywicki, *Savior or Menace?*, supra note 31.

[36] *See* Christopher Mufarrige and Todd Zywicki, *The Limits of Consumer Protection* (working paper, Sept. 2020); *see also* Frank Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1 (1984).

[37] Brian Johnson, Acting Deputy Director, Consumer Financial Protection Bureau, "Toward a 21st Century Approach to Consumer Protection," Remarks to Consumer Action (Nov. 15, 2018), available in https://www.consumerfinance.gov/about-us/newsroom/toward-21st-century-approach-consumer-protection/.

[38] *See* NCCF Report, *supra* note 1, at Chapter 3.

The economics of debt collection and creditors' remedies is straightforward.[39] With respect to the supply of credit, creditors will be less willing to lend if they are unable to reliably collect their debts and will charge higher prices in expectation of higher loss rates (which, in turn, will lead to less lending and still higher prices).[40] Allowing legal recourse, but imposing various limits on specific debt collection practices, will not deter lending completely but will raise the risk and loss rates from lending. In turn, higher risk and loss rates will raise costs, forcing lenders to raise their prices to offset those losses (such as by raising interest rates, requiring down payments, or other term repricing behavior). Restrictions on useful creditors remedies, therefore, will have an overall effect of increasing the price and reducing the quantity supplied of credit for all consumers but especially higher-risk borrowers.

The demand side, however, will exhibit the opposite dynamics. In deciding whether to borrow, consumers will consider the total costs of the loan, including not just the nominal price of the loan (such as the interest rate) but also the expected cost of potential default. Harsher and more immediate remedies will be more costly to some consumers than others but will be especially relevant to those who are most likely to default. Limiting remedies, therefore, will increase the quantity demanded of consumer credit, as consumers will be more willing to borrow and take on credit where the consequences of delinquency and default are less costly.[41]

A restriction on creditors' remedies, therefore, will have two simultaneous and offsetting impacts: it will simultaneously reduce the quantity supplied of credit and increase the quantity demanded.[42] Thus, the end result will unambiguously be a higher equilibrium price for credit, but the equilibrium quantity of credit could be either lower *or* higher, depending on how lenders and borrowers adjust to the new mix of prices and remedies.

The point can be illustrated in Figure 6-1.

FIGURE 6-1: EQUILIBRIUM PRICE-QUANTITY OF CREDIT

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[39] See Todd J. Zywicki, The Law and Economics of Debt Collection and Its Regulation, 28 Loyola Consumer L. J. 167 (2016).

[40] *Id.* Note that legal recourse is not the only way in which creditors collect debts. Consumers voluntarily repay debts in order to preserve access to credit in the future or to avoid adverse consequences for their reputation as transmitted through their credit rating. Legal recourse, therefore, is one additional mechanism at the margin that can be relied on to collect debts. For simplification we focus on legal recourse here. *See* Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J. of L. Econ. & Org. 5 (1985).

[41] Note that the economics of interest rate controls are identical—lenders will reduce the quantity supplied of loans and consumers will increase their demand for credit at the controlled price.

[42] Zywicki, *Debt Collection*, *supra* note 39.

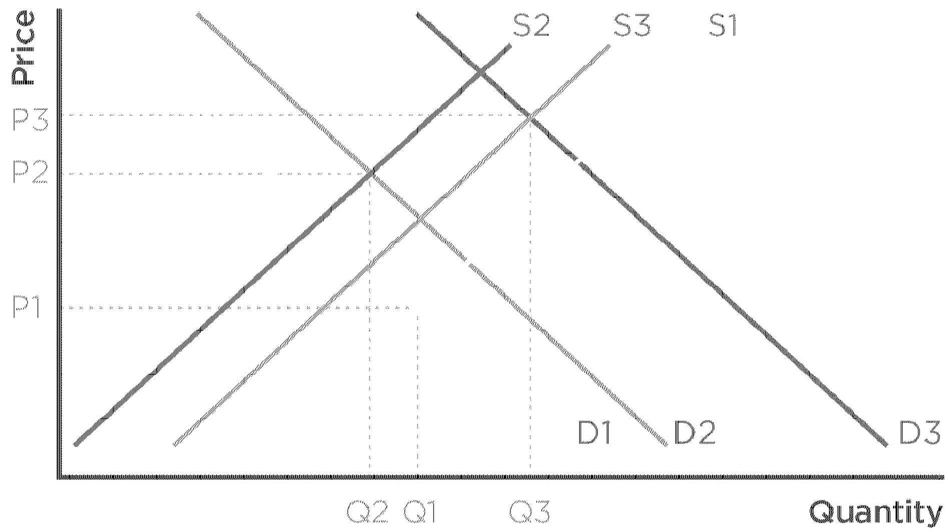

Figure 6-1 illustrates an inefficient restriction on creditors' remedies that reduces the equilibrium quantity of credit. Although consumer demand shifts out from D1 to D2, the supply shift from S1 to S2. In other words, the hypothetical restriction illustrated in Figure 6-1 is harmful to consumers in that the reduced supply (and increased price) that results from the new restriction exceeds the value that consumers place on it.

If Q2 were to right of Q1, meaning that equilibrium quantity of credit increased, then the hypothetical restriction would be welfare-enhancing. That result would indicate that the consumer places a higher monetary value on the elimination of that potential remedy than the increased cost necessary to obtain it, and consumer welfare would be improved overall. Notably, this result suggests that there is no reason to believe that there is an inherent conflict of interest or zero-sum relationship between consumers and providers of financial products. Sound and efficient consumer credit regulation should be viewed as positive sum in nature, as by increasing consumer confidence, it will increase consumer demand for those products and services, thereby benefiting consumers, providers, and the economy overall.[43]

Empirical studies of the effects of restrictions on creditors' remedies that followed the NCCF Report and the FDCPA suggested that many of those rules might have reasonably been concluded to be economically efficient in that they eliminated practices that were of minimal value to

[43] *See* Todd J. Zywicki, *The CFPB Could Be a Force for Good*, Wall St. J. (Feb. 19, 2018). Similarly, although consumers are liable for the first $50 of losses associated with credit card fraud, virtually all credit card issuers waive that obligation and fully reimburse the consumer, in order to provide the consumer with confidence to use the card free from that risk.

financial services providers but were strongly disliked by consumers. Indeed, as discussed below, many of the creditors' remedies that were barred already were little used by most creditors for precisely this reason.

Regulation will have distributional effects in addition to efficiency effects. Interest-rate ceilings on consumer financial products traditionally have been justified as beneficial for low-income consumers. As is the case with the effect of usury laws, inefficient restrictions on creditors' remedies will also end up hurting higher-risk consumers more than lower-risk consumers.[44] Inefficient regulations increase the costs of collections by reducing the efficacy of collection measures, thereby increasing losses and reducing the returns per dollar invested in collections. As a result, restrictions on creditors' remedies will increase the risk and cost of lending to all potential borrowers but will increase the risk of lending to higher-risk consumers most. *Ex post*, riskier consumers would benefit most from strict restrictions on collection activities as they are most likely to default and be subjected to collection efforts. But *ex ante*, these same consumers are those who are most likely to be harmed from excessively strict limits on creditors' remedies once offsetting adjustments by creditors are taken into account. Regulatory limits will lead to compensating adjustments by lenders to reduce losses, most notably leading to higher lending underwriting standards and rationing lending to riskier consumers (as well as reducing available credit lines to most consumers), but also higher interest rates, requiring larger down payments, and shorter maturities (resulting in higher monthly payment obligations).[45] Lower-income consumers will have greater difficulty coming up with liquid funds for a larger down payment or meeting higher monthly payment obligations than will higher-income consumers.[46] In addition, there are many costs associated with collecting debts that do not scale one-to-one with the size of the loan; as a result, smaller loans are more expensive to collect per dollar loaned than larger

[44] *See* Zywicki, *Debt Collection*, *supra* note 39.

[45] See Douglas F. Greer, Creditors Remedies and Contractual Provisions: A Legal and Economic Analysis of Consumer Credit Collections, in 5 Technical Studies of the National Commission on Consumer Finance 154 (1973); James A. Barth, et al., The Effect of Government Regulation of Personal Loan Markets: A Tobit Estimation of a Macroeconomic Model, 38 J. Fin. 1233 (Sept. 1983); James R. Barth, Joseph J. Cordes, & Anthony M. Yezer, Benefits and Costs of Legal Restrictions on Personal Loan Markets, 29 J. L. & Econ. 357 (1986); William C. Dunkeberg, Banks Lending Response to Restricted Creditor Remedies (Credit Research Ctr. Working Paper No. 20, 1978); Viktar Fedaseyeu, Debt Collection Agencies and the Supply of Consumer Credit, Fed. Res. Bank of Philadelphia Research Department Working Paper WP 20-06 (Feb. 2020).

[46] Higher-income consumers are also more likely to have access to assets that can provide collateral for a loan, such as home equity lines of credit. *See* Zywicki, *Debt Collection*, *supra* note 39; *see also* Richard M. Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 Am. L. & Econ. Rev. 168 (2002).

loans.[47] As a result, lenders will also raise their minimum loan size to an amount that is economically feasible to collect.[48] Higher minimum loan size will exclude low-income and higher-risk borrowers that could have qualified for a smaller loan but are unable to be underwritten at a larger loan size. Overall, therefore, although economically inefficient restrictions on creditors' remedies benefit those borrowers who do not pay their obligations, they create costs for other higher-risk consumers who pay higher interest rates and gain less access to credit.[49]

Much of modern debate over the scope and substance of consumer financial regulation rests on an implicit assumption that consumer financial regulation must be zero-sum in nature, i.e., that regulation rests on a zero-sum single dimension continuum of conflict between "consumers" and "industry" and that any reduction in the cost of consumer financial regulation (i.e., "deregulation") must be "good" for industry and "bad" for consumers, and vice-versa. The Taskforce rejects this zero-sum conception as a useful way to think about consumer protection law; indeed, it rejects the usefulness of the idea of "deregulation" generally. Instead, the Taskforce recognizes the crucial role played by well-designed consumer protection rules, regulations, and enforcement, not only in protecting consumers from fraud and other oppressive practices, but also in protecting upstanding businesses from market distortions caused by fraudulent businesses and the adverse effects on consumer confidence that those practices can cause. As a result, the Taskforce expressly rejects the construct of "deregulation" versus "more regulation" as a useful way of thinking about consumer protection. Instead, the Taskforce believes that the overall objective of consumer financial protection policy should be to adopt rules, regulations, and practices that protect consumers from harm; improve consumer welfare overall; promote fair and transparent markets and eliminate practices that interfere with that goal. Rules that promote transparency and facilitate shopping, such as well-designed information disclosure rules, and rules that promote fair treatment of consumers, such as well-designed limits on creditor remedies, can provide benefits to consumers, providers, and the overall economy.

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[47] For example, the cost of making a phone call or sending a collections letter is largely the same regardless of the size of the obligation being collected, thus there is some minimum loan value amount below which it would not be economical to collect in the event of default.

[48] *See* Dunkelberg, *supra* note 45, at 9.

[49] *See* Zywicki, *Debt Collection*, *supra* note 39.

6.2.2 The Role of Consumer Financial Protection Regulatory Agencies

The institutional framework of consumer protection, including consumer financial protection, has been described through the analogy of a "three-legged stool."[50] As then-Acting CFPB Deputy Director Brian Johnson explained the three-legged stool idea in a speech in November 2018:

The first leg is competition through the marketplace. The second is the framework of contract rights, property rights, and related legal obligations executed and enforced through the legal system. The third leg is public agencies. When competition and contract rights cannot adequately restrain market participants who don't play by the rules, public agencies must help bear the weight of policing the markets.[51]

Each of the three legs of the stool reinforce each other and make the system more stable, "Just as a two-legged stool is unstable, markets and private legal rights, while indispensable to the American economy, falter unless buttressed by a third leg."[52] The third leg of the stool in the United States is public agencies, which can help the other legs work better, such as by creating a framework that enables market competition to work better.[53]

Competition

The first leg of the stool is competition and the market process. It is recognized that competition brings about lower prices and greater variety for consumers. Often overlooked, however, is that competition also promotes consumer protection goals. By giving consumers a variety of providers of financial products and services in the market, dissatisfied consumers can walk away from low-quality or underperforming companies. This threat of punishment for businesses that do not satisfy their customers can provide a powerful check on opportunism and low quality.[54] Often, the economic fallout from a scandal or reports of consumer mistreatment will far exceed the costs

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[50] *See* Johnson, *supra* note 37; *see also* J. Howard Beales III & Timothy J. Muris, *FTC Consumer Protection at 100: 1970s Redux or Protecting Markets to Protect Consumers?*, 83 George Washington L. Rev. 2157 (2015). The three-legged stool analogy is adapted from Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 Tex. Rev. of L. & Pol. 393, 400 (2001).

[51] Johnson, *supra* note 37.

[52] Beales & Muris, *supra* note 50, at 2163.

[53] As discussed below, we include within this third leg of the stool the value of competitive federalism and experimentation among different state regulatory systems.

[54] *See* L. G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. Bus. 27 (1980); Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615 (1981).

to the company from any direct regulatory costs or fines.[55] Jobs are frequently lost, including those of senior management. In addition, trusted third-party evaluators, such as Consumer Reports or JD Power, provide valuable information about various providers of services.

Advertising also provides information about new products and services as well as comparative information about rival sellers.[56] For example, Southwest Airlines has made its tag line "Bags Fly Free" and other elements of price transparency a defining characteristic of its customer brand, along with eschewing other similar fees, such as schedule change fees and the like. According to a subsequent analysis, although Southwest's decision to forego such fees cost it an estimated $500 million per year in new revenues, the company more than offset that amount by increasing its market share by two percentage points, increasing passenger loads by 10 percent, and $2 *billion* in incremental annual revenue.[57]

The importance of competition and responsiveness to consumer demand applies to the consumer financial services industry as well as other consumer markets. For example, when the CFPB asked consumers what steps they would take if they felt like they had been charged an incorrect fee, a majority said that they would cancel their credit card and change to a different issuer.[58] Survey research conducted by the Federal Reserve suggests that this threat by consumers is credible as 92 percent of consumers report that they "can easily get a credit card from another company if they are not treated well."[59]

Given this high degree of competition and ease with which consumers can abandon unsatisfactory providers, it is not surprising that consumers generally express a high degree of satisfaction with their credit card providers. According to the Federal Reserve, 95 percent of consumers express that they are "generally satisfied" in their dealings with credit companies and

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[55] *See* Thomas D. Dowdell, Suresh Govindaraj, and Prem C. Jain, *The Tylenol Incident, Ensuing Regulation, and Stock Prices*, 27 J. Fin. and Quantitative Analysis 283 (1992); Mark L. Mitchell and Michael T. Maloney, *Crisis in the Cockpit? The Role of Market Forces in Promoting Air Travel Safety*, 32 J. L. & Econ. 329 (1989); Mark L. Mitchell, *The Impact of External Parties on Brand-Name Capital: The 1982 Tylenol Poisonings and Subsequent Cases*, 27 Econ. Inquiry 601 (1989).

[56] The role of advertising in the competitive process is discussed in greater detail in Chapter 7.

[57] *See* Geoffrey Manne & Todd J. Zywicki, *Uncertainty, Evolution, and Behavioral Economic Theory*, 10 J. L. Econ. & Pol'y 555 (2014).

[58] Consumer Financial Protection Bureau, Arbitration Study Section 3 page 3 (March 2015).

[59] Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards*, 99 Fed. Res. Bulletin 1 (Issue 5, Dec. 2013); *see also* Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970–2000*, 86 Federal Reserve Bulletin 623 (200).

only 5 percent express that they are dissatisfied. In addition, 93 percent of customers believe that credit card companies treat them fairly versus only 7 percent who disagree.[60]

In turn, financial service providers seek to keep their customers happy in order to preserve the benefits of the relationship as well as the company's positive reputation with customers. Acquisition of new customers is expensive, and banks will find it far less expensive in the long run to keep a loyal customer satisfied than to fight over a few overdraft or late fees. Thus, the first step most consumers take if they feel that they have been assessed an unfair fee is to complain to the bank and ask for a refund, with the implied threat of changing banks if they are not satisfied. This desire to retain consumers often leads the bank to voluntarily issue a refund. Examining the reports of one medium-sized regional bank, for example, Johnston and Zywicki found that overall, in about 68 percent of cases in which consumers complained about a fee (such as an overdraft fee or wire transfer fee), the bank issued a complete refund.[61]

The value of treating customers fairly is illustrated by the public response to the infamous Wells Fargo "fake account" scandal that came to light in 2016.[62] A survey of consumers soon thereafter found that "positive perceptions" of the bank fell from 60 percent before the scandal to 24 percent after the scandal, while negative perceptions increased from 15 percent before the scandal to 52 percent post-scandal. In addition, 30 percent of Wells Fargo customers stated that they were actively exploring other alternative banks, and 14 percent had already made the decision to switch banks as a result of the scandal. Overall, one analysis estimated that Wells Fargo would lose approximately $99 billion in deposits and $4 billion in revenue as a result of customer fallout from the scandal. Moreover, only 3 percent of potential new customers stated that they would be willing consider doing business with the bank.[63]

Social media has increased the potential reputational harm to financial services providers from satisfied dissatisfied consumers by amplifying their experiences. Websites such as Yelp and Google enable consumers to testify directly to their experiences with various providers and products. Testimonials of actual consumer experiences ameliorate the traditional information asymmetries between consumers and providers of services, even in traditional redoubts of

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[60] Canner & Elliehausen, *supra* note 59.

[61] *See* Jason Scott Johnston & Todd Zywicki, *The Consumer Financial Protection Bureau's Arbitration Study: A Summary and Critique*, 35(5) Banking & Fin. Servs. Pol'y Report 9, 20 (May 2016).

[62] *See* Matt Egan, *Wells Fargo's Reputation is Tanking, Survey Finds*, CNN.com (Oct. 254, 2016), *available in* https://money.cnn.com/2016/10/24/investing/wells-fargo-fake-accounts-angry-customers/index.html (summarizing report by cg42 consulting).

[63] *Id.*.

government regulation, such as occupational licensing. Recent research finds that consumers today place greater value on the experiences of other consumers, as measured by online reviews, than they do on traditional criteria such as government-issued licenses.[64]

Credible third-party experts also provide valuable information to consumers about goods and services that are complex or are credence or experience goods about which consumers cannot verify quality until they actually use those products and sometimes even after they use the product. Organizations such as JD Power and *Consumer Reports* provide information on a variety of goods and services, including bank accounts, credit cards, mutual funds, and other financial products and services. In recent years this traditional mix has been supplemented by a variety of other expert sites that will assess and grade financial products, such as WalletHub.com and NerdWallet.com. Purported market "failures," therefore, can produce responsive market "solutions" as a result of consumer demand and the competitive process. Information about those products and services is useful to consumers and creates a profit opportunity for those who can help deliver reliable, user-friendly information to consumers.

On the other hand, despite these many and varied ways that markets provide assurance to consumers about the quality of the goods, services, and providers that they consume and with whom they interact, there may nevertheless be residual market failures from information asymmetries, "externalities," or market power that markets are unable to correct for themselves because of high transaction costs or poorly-specified property rights. These limitations create the need for the common law and regulatory agency legs of the stool.

Common Law

Common law rights and remedies—namely contracts, property, and tort—provide the second leg of the stool by providing a mechanism for consumers to vindicate their rights in situations in which sellers defraud or harm consumers. Legal enforcement of contract terms and protection against fraudulent practices supplement the competitive process in providing consumer protection to consumers and making markets work more effectively.

Market forces, particularly the desire to retain repeat customers and to prevent adverse reputational consequences provide a powerful motive for keeping one's promises and eschewing fraud. But there are limits to this incentive for self-enforcing promises. For example, a seller might believe that there is a low likelihood that a consumer might detect the improper behavior

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[64] *See* Chiara Farronato, Andrey Fradkin, Bradley Larsen, & Erik Brynjolfsson, *Consumer Protection in an Online World: An Analysis of Occupational Licensing*, NBER working paper w26601 (Jan. 2020).

and thereby punish the miscreant business. Or the seller might face attenuated competitive constraints, such as market power, that enable them to cheat consumers with minimal fear of punishment. Or the seller might simply believe that the short-term benefit of cheating a consumer or group of consumers exceeds any damage to the business's reputation at large. Regardless of the possible source of market failure, legally enforceable private rights of action for fraud, warranty, and the like, provide a vehicle for wronged consumers to vindicate their rights and gain recompense from seller misbehavior.

But reliance on common law rights and private lawsuits to protect consumers is imperfect as well. In the first instance, vindication of common law rights places the burden on individual consumers to bring a legal action and some consumers might be unwilling or unable to do so. Wronged consumers might be reluctant to initiate a lawsuit because of the legal fees involved or because of the stress of initiating litigation. Consumers might also have limited incentive to initiate a lawsuit, particularly where the loss to any individual consumers is small relative to the cost of litigation. Arbitration and other types of alternative dispute resolution reduce the costs of conflict resolution and thereby enable consumers to better vindicate their rights without requiring a lawyer and extensive litigation. Arbitration tends to be relatively informal and often does not require a lawyer. Lawsuits, by contrast, are highly formal, and failure to use a lawyer risks running afoul of the various rules and complexities of court proceedings, resulting in the dismissal of one's case.

Cases in which the harm to any individual consumer is small or difficult to detect are particularly problematic. The low probability of detection might render market protections somewhat ineffective. And the small amount of harm to each consumer might undermine their incentive to sue. But from the perspective of a fraudulent seller, these types of harms might be particularly lucrative, as the large number of consumers adversely affected provides an opportunity to collect large sums of ill-gotten gains.

In theory, class action lawsuits provide a mechanism for pooling together many small claims of wrongdoing and thereby creating an incentive to sue. But class action proceedings are riven with their own problems for consumers, most notably that the small stakes involved in any given case for an individual plaintiff tempers the incentive for any one of them to monitor the actions of their lawyers closely.[65] This can produce class actions settlements that are far more beneficial for

[65] *See* Jason School Johnston and Todd J. Zywicki, *The CFPB's Arbitration Study: A Summary and Critique*, 35(5) Banking and Fin. Servs. Pol'y Report 9 (2016).

class counsel than for class members, as class members might receive nominal redress while their lawyers receive substantial legal fees.

Moreover, as Jason Johnston has observed, some class action cases are brought despite an absence of tangible harm to any consumer.[66] These "no harm" cases produce no obvious benefit to consumers because of the absence of any harm, yet they impose a cost on the company that must eventually be passed on to other customers. Often these cases involve claims to vindicate laws that provide for a minimum size of "statutory damages" for a violation, such as $500 or $1000 per violation, without requiring showing of actual harm to the consumer. Ironically, statutory damages were often provided in the first place in order to provide adequate economic incentives for individual plaintiffs to sue in response to alleged violations by providing sufficient damages to make such a suit economically worthwhile. When combined with the class action process, however, the presence of statutory damages can dramatically increase the damages for a violation that far exceeds any actual harm to consumers from the violation.[67]

Common law rights, therefore, can supplement market mechanisms in situations in which consumer harm occurs notwithstanding market incentives not to cheat. Yet even though common law rights and remedies are a powerful supplement to market mechanisms, they too can solve some problems but retain problems of their own. The primary responsibility for vindicating common law rights rests on the individual consumer, which can result in inadequate incentives for consumers to do so. This can especially be a problem when harm to any individual consumer is small, but many consumers are harmed.

6.2.3 Regulatory Agencies

The third leg of the consumer protection stool is public agencies at the state and federal level. As with the other two legs, the leg of public regulatory agencies is to stabilize the stool by reinforcing the other two legs of the stool. Making this third leg too large relative to the other legs or placing it in too central of a position in the system will make the stool less steady and unbalanced. Moreover, not only is it essential to understand the relative position of public agencies in

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[66] See Jason Scott Johnston, High Cost, Little Compensation, No Harm To Deter: New Evidence on Class Actions Under Federal Consumer Protection Statutes, 2017 Colum. Bus. L. Rev. 1 (2017).

[67] It is unclear to what extent the Supreme Court's decision in *Spokeo, Inc. v. Robins*, 136 S. Ct. 1540 (2016), might mitigate this problem with statutory damages. Lower court applications of *Spokeo* to various statutes and fact situations remain unsettled. *See, e.g.*, *Trichell v. Midland Credit Management*, 954 F.3d 990 (11th Cir. 2020) (holding that plaintiff lacked standing to sue under the Fair Debt Collection Practices Act where he could show no "concrete injury" from misleading communication).

supporting the overall structure of consumer protection, there is the additional question as to *which* level of government, state or federal, is the best one to deal with any particular consumer harm.

Well designed and executed public agencies are essential to the institutional framework of consumer protection. They can help markets work better for consumers and address market failures when market and common law responses are insufficient to maximize consumer welfare. By preventing fraud and other harms to consumers, public agencies can help ensure that the competitive process is fair and efficient for consumers.[68] Much of the Taskforce's effort has been devoted to identifying ways to help public agencies work better.

In most instances, public agencies should be seen as a last resort, rather than first resort, for dealing with potential market failure. Regulation and public enforcement actions are blunt instruments for dealing with potential consumer harms and run the risk of unintended consequences. Market processes are grounded in the concrete choices of individual consumers and individual financial services providers; thus, those processes can provide highly nuanced and personalized product and service attributes to individuals or small groups of consumers. Similarly, common law rests on actual harms that arise from particular consumers' interactions with providers. Public agency action, by contrast, is concerned with larger more abstract groups of consumers and providers. This has certain efficiencies associated with it, but in providing recourse or harm-prevention to large categories of consumers, public agency action sacrifices the individualized nature of market and common law decision-making. Moreover, by creating highly generalized rules that eventually will apply to particular persons in particular contexts, agency action will produce unintended consequences where the rule or enforcement action fits imperfectly with the needs and preferences of particular consumers and providers.

In contrast to private ordering through market transactions and voluntary contracts, agency action can be understood a type of central planning, where the agency creates general rules that apply to categories of transactions. As a result, just as markets and common law "fail" in certain predictable contexts, government agencies (and legislatures) predictably "fail" as well.[69] Two factors stand out: (1) the knowledge problem and (2) the problem of incentives.

First, agencies, like other central planners, suffer from the knowledge problem associated with central planners seeking to collect and synthesize information that is then transmitted as data

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[68] *See* discussion in Chapter 8.

[69] *See* Maxwell Stearns, Todd J. Zywicki, and Thomas Micelli, Law and Economics: Private and Public 798-806 (discussing characteristics of agency decision-making).

into decisions by consumers and businesses.[70] Although agencies can collect data and other types of evidence, this information is not the same as the knowledge of "time and place" that arises from particular individuals making particular decisions in particular contexts under particular constraints.[71] For example, most auto title pawn customers are consumers. Yet research indicates that some customers who appear to be ordinary individuals are actually small, independent businesspeople who use their vehicle (van or pickup truck, for example) as a source of short-term business finance.[72]

For example, a landscaper might pledge his truck on Monday to gain access to cash to buy mulch, sod, bushes, and labor, then perform yardwork the next two days and be paid at the end of the week at which he will redeem the vehicle loan. A handyman or painter might similarly pledge his or her vehicle to access short-term cash to purchase supplies that is repaid just a few days later on completion of the job. As a result, a particular individual might access multiple loans over a several month period, but each one is repaid quickly, with a high degree of certainty, and with minimal interest charges. To the regulator, however, this individual might appear to be a one-size-fits-all individual caught in a so-called "debt trap" who borrows repeatedly. The lender and customer, by contrast, are more likely to know the real purpose of the transactions and whether they are problematic. Selecting an arbitrary variable, such as the number of loans that a borrower is permitted to use, can also produce harmful adjustments and offsetting behavior by borrowers, such as keeping an auto title loan outstanding for a longer period of time, or borrowing a larger amount of money than needed as a hedge against future needs, that could produce more finance charges than would otherwise occur.

Another example is that of consumer usage of overdraft protection.[73] When queried in the abstract about whether they would want the ability to be able to use overdraft protection on their debit card, a large minority of consumers say no. But when asked if they would like to have access to overdraft protection *in emergency situations*, a large majority of consumers say that they would, indicating that they plainly had not thought of that scenario under the generic phrasing of

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[70] *See* Christopher Mufarrige and Todd J. Zywicki, *Simple Rules for a Complex Regulatory World: The Case of Financial Regulation*, __ European J. of L. & Econ. __ (Forthcoming 2021).

[71] *See* F.A. Hayek, *The Use of Knowledge in Society*, 35 Am. Econ. Rev. 519 (1945).

[72] See Todd J. Zywicki, Consumer Use and Government Regulation of Title Pledge Lending, 22 Loyola Consumer L. Rev. 425 (2010); Jim Hawkins, Credit on Wheels: The Law and Business of Auto-Title Lending, 69 Wash. & Lee L. Rev. 535 (2012).

[73] See Adam C. Smith and Todd Zywicki, Behavior, Paternalism, and Policy: Evaluating Consumer Financial Protection, 9 NYU J. L. & Liberty 201 (2015).

the question and then changed their mind when that situation was presented to them.[74] In short, consumers themselves may not always know the choices that they would make in particular contexts until they are actually confronted with those choices.[75] Moreover, when confronted with the exact same choice in the exact same situation, different individuals might make different choices. For example, depending on their situation and personal preferences, one person might be willing to borrow money to buy a minivan when they have children, while someone else might not be willing to do so until they saved up enough to purchase it with cash. In short, the economic value that people place on various consumption goods and the use of credit to purchase them is "subjective"—not only do different people choose differently from one another, the *same* person might make different choices in different contexts or at different times.[76] Unless it is done carefully, government regulation intended to help can actually harm consumers if it fails to take account of these subjective preferences that people hold and the different contexts in which they make decisions.

A second danger with agency action and government regulation is the problem of incentives, both from external interest-group pressures as well as the agency's internal dynamics.[77] Just as the incentives of providers of financial services and class action lawyers sometimes can be imperfectly aligned with maximizing consumer welfare, government officials can face imperfectly aligned incentives as well.

Where authority for consumer protection law and policy is guided by an elected official, such as a state attorney general (AG), optimal long-term consumer protection policy can be imperfectly aligned with short-term political incentives. In carrying out their enforcement activities, elected AGs will have at least one eye focused on the political elements and consequences of their actions, both for the electorate at large but also for important interest groups that disproportionately influence the AGs political fate either for re-election or for promotion to

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[74] *See* Board of Governors of the Federal Reserve System, Design and Testing of Overdraft Disclosures: Phase Two 18-19 (Oct. 12, 2009).

[75] Thomas Sowell, Knowledge and Decisions 218 (1980) ("The real problem is that the knowledge needed is a knowledge of *subjective patterns of trade-off that are nowhere articulated*, not even to the individual himself. I might *think* that, if faced with the stark prospect of bankruptcy, I would rather sell my automobile than my furniture, or sacrifice the refrigerator rather than the stove, but unless and until such a moment comes I will never *know* even my own trade-offs, much less anybody else's.").

[76] Todd J. Zywicki, A Unanimity-Reinforcing Model of Efficiency in the Common Law: An Institutional Comparison of Common Law and Legislative Solutions to Large-Number Externality Problems, 46 Case Western L. Rev. 961 (1996) (discussing subjective value); James M. Buchanan, Cost and Choice: An Inquiry in Economic Theory (1969).

[77] *See* James M. Buchanan and Gordon Tullock, The Calculus of Consent 204-212 (1999) (originally published 1962); Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups (1965).

higher office.[78] Elected officials also tend to overweight the short term benefits and costs of consequences of actions relative to the long term. In addition, AGs also will have their own personal policy agendas they desire to promote while in office.[79] How these various and competing political influences of the public, interest groups, and their own personal agendas will play out in practice is difficult to predict. What is not difficult to predict, however, is that the agency's consumer protection agenda will be influenced by political considerations as well as what factors constitute optimal long term policy for consumers.[80]

Federal agencies led by appointed officials and career employees face different external and internal political influences from elected officials. Executive agencies technically report to the President, who is democratically accountable to the electorate. Although politics and special-interest influence is attenuated in this process, there is little doubt that political calculations enter into the agenda of executive agencies through Presidential appointments and control. Congress also provides political influence over Executive agencies through its oversight and budgetary control. Independent agencies are somewhat more independent of Presidential control. Yet this does not mean that they are immune to political influences. Research suggests that independent agencies are substantially influenced by Congress through a variety of formal and informal means.[81]

But eliminating external democratic oversight does not eliminate the influence of politics and ideology. Agencies are also subject to internal political pressures arising from their staff. Precisely because of the attenuated external political control over public agencies, the staff of those agencies has a greater range of discretion to influence policy and to advance their own ideological and personal goals. In some instances, this discretion permits agency employees to aggressively expand the agency's reach to regulate behavior beyond that which is reasonably in its scope.[82] To some extent, this imperialistic drive arises from the natural self-interest of agency personnel to advance their own careers and to expand the power, prestige, and budget of the

[78] See Colin Provost, The Politics of Consumer Protection: Explaining State Attorney General Participation in Multi-State Lawsuits, 59 Political Research Quarterly 609 (2006).

[79] See Colin Provost, An Integrated Model of U.S. State Attorney General Behavior in Multi-State Litigation, 10 State Politics and Policy Quarterly 1 (2010).

[80] See Colin Provost, When is AG Short for Aspiring Governor? Ambition and Policy Making Dynamics in the Office of State Attorney General, 40 Publius: The Journal of Federalism 597 (2010).

[81] See Barry R. Weingast and Mark J. Moran, Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission, 91 J. Pol. Econ. 765 (1983).

[82] *See* Stearns, Zywicki, & Micelli, *supra* note 69, at 781-98 (2018).

agency.[83] In addition, staff employees have their own ideological and political views that can dramatically influence the agency's direction and temper efforts to redirect the agency's mission in accordance with either the President's or Congress's vision.[84] Professor Roberta Romano has argued that the CFPB's lack of democratic oversight has also led it to favor less transparent and less publicly accountable mechanisms for policy making.[85] Moreover, those who head agencies might have future elective or appointive political ambitions themselves, which could influence their decision-making while running the agency.[86] In general, the greater the degree of independence and insulation of agencies from oversight and control by democratically-elected officials, the greater also will be the opportunities for those within the agency to shape it according to their own goals and vision rather than those of the democratically-accountable officials.[87]

Thus, just as "market failure" predictably can occur, so can "political failure."[88] As a result, just as markets and common law are imperfect institutions, legislative and regulatory bodies are imperfect as well. In determining the optimal allocation of authority among various institutions it is important to avoid the "Nirvana Fallacy," i.e., the assumption that just because one institution is imperfect that some other institution must function better.[89] How regulatory agencies can assess the wisdom and efficacy of interventions is discussed below.

Special Cases of Market Failure

Economists have identified several general situations in which market failure may occur, such as asymmetric information, externalities, and market power (i.e., monopoly power) by sellers. In addition, there is another discrete category of consumer interactions that plainly have the

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[83] *See* William A. Niskanen, Jr., Bureaucracy and Representative Government (1971).

[84] See Timothy J. Muris, Regulatory Policymaking at the Federal Trade Commission: The Extent of Congressional Control, 94 J. Pol. Econ. 884 (1986); Zywicki, Savior, supra note 35.

[85] See Roberta Romano, Does Agency Structure Affect Agency Decisionmaking: Implications of the CFPB's Design for Administrative Guidance, 36 Yale J. on Reg. 273 (2019).

[86] Zywicki, *Savior*, *supra* note 35.

[87] This is a phenomenon known as "agency drift" as the agency's actions "drift" from the policy preferences of the enacting Congress. *See* David Epstein and Sharyn O'Halloran, *Administrrative Procedures, Information, and Agency Discretion*, 38 Am. J. Pol. Sci. 697 (1994).

[88] James M. Buchanan, *Market Failure and Political Failure*, 8(1) Cato J. 1 (1988).

[89] Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J. L. & Econ. 1, 1 (1969) ("In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient.").

potential to produce market failure for consumers: namely, those in which the consumers are affected by a firm's behavior, yet consumers lack the opportunity or authority to choose the firm that provides the services. Although there are clear economic justifications for why these industries are structured as they are, they can nevertheless lead to potential problems for consumers since those firms are paid by and owe their allegiance to some other party.

Examples of service providers that provide consumer services but which the consumer lacks the authority to control, hire, and fire, include those such as debt collectors, credit reporting agencies, and mortgage servicers. Not coincidentally, the consumer reporting industry and debt collection industry are the top two sources of consumer complaints in the CFPB's Consumer Complaint Database, and mortgage complaints rank fourth.[90]

The rationale for this market arrangement with respect to these providers is clear, notwithstanding their potential for consumer harm. Consider the debt collection industry. As discussed above, fair and reliable collection of consumer debts is essential for a well-functioning consumer economy. If creditors are unable to collect debts at reasonable cost and with reasonable certainty, then they will be less likely to lend in the first place, especially to riskier borrowers. On the other hand, if creditors can invoke tactics that are perceived as excessive and unfair by consumers, then consumers will be less likely to borrow in the first place. This leads to the implication of an optimal level of debt collection efforts that will enable creditors to collect debts efficiently while protecting consumers from overreaching practices that make them worse off

Empowering delinquent consumers to choose their own debt collectors would be unlikely to produce an optimal level of vigilance in debt collection activities. Although consumers as a whole, including future borrowers, would benefit from striking the right balance, delinquent debtors invariably would favor debt collection efforts that were too generous. This would enable those consumers to avoid repaying their obligations, losses that would be passed on to other consumers in higher prices and reduced supply of credit, especially to higher-risk borrowers. On the other hand, when the choice is left up to the creditor without the consent of the borrower, there is a fear that the creditor's collection efforts might be excessively aggressive toward the borrower.

But while this symmetrical conclusion intuitively suggests the presence of a market failure, it is incomplete. Although third-party debt collectors potentially might be over-aggressive in their

90 All together those three industries comprised 73 percent of all the complaints in the CFPB's database in 2019. *See* Consumer Financial Protection Bureau, Consumer Response Annual Report, January 1-December 31, 2019, at 9, Fig. 2 (March 2020).

collection efforts in some cases, a creditor that collects its own debt might be insufficiently aggressive from an economic perspective. In particular, where the debtor stands in a repeat-dealing relationship with the creditor, it is not necessarily the case that collection efforts might be too aggressive. In fact, they might actually be somewhat less aggressive than optimal. That would be the case, for example, if the lender is a retailer extending credit to an existing customer. The retailer would obviously be concerned about collecting past due debt. But the retailer would balance this concern of minimizing losses on past due accounts, which would support aggressive collection measures, against a countervailing pressure to retain the customer for future shopping purchases. In the latter instance, the retailer might be more passive in collecting past due debt than otherwise would be economically efficient, with some of those losses being passed on to other consumers.[91] And, consistent with that idea, data collected by the NCCF suggested that retailers carried unpaid customer balances longer than other creditors such as banks and finance companies.[92] This does not necessarily demonstrate that other creditors were pursuing efficient debt-collection strategies and retailers were not, but it demonstrates the importance of repeat-dealing in shaping behavior regarding debt collection.

Third-party credit cards, such as bank-issued cards under the Visa or MasterCard logo or American Express or Discover, address part of this problem by enabling retailers to outsource the task of becoming creditors in the first place. Retailers can thereby concentrate on selling goods to consumers, which is their area of expertise, and can outsource the cost and risk of running credit operations and the unpleasantness of trying to collect delinquent debt from an otherwise good customer. Third-party debt collectors help to address this incentive problem with respect to optimal levels of collection efforts as well. By outsourcing debt collection to third parties, the original issuers of the debt can effectively collect the debt while insulating themselves from some of the repeat-dealing and reputational consequences associated with carrying out the combative process of debt collection.[93] Third-party collectors can thus be expected to be more aggressive than originating creditors in collecting debts, which will which will reduce losses and increase recoveries.

But lenders are not likely to escape adverse reputational consequences completely. Few borrowers are likely to know the identity of agency trying to collect past-due accounts (and would have no reason to pay attention for future reference) but most are likely to know the identity of the issuing entity and can be expected to hold the behavior of the debt-collection agency against

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[91] *See* Zywicki, *Debt Collection*, *supra* note 39.

[92] *Id.*

[93] Zywicki, *Debt Collection*, *supra* note 39.

the originator. This means that indirectly the originator of the debt does stand in an ongoing or repeat-dealing relationship with the consumer. Therefore, even though consumers may have limited power to punish the collection agency directly, they can still do so indirectly through their dealings with the originating creditor. As a result, even though the consumer has little power directly against the collection agency, the originating creditor does and would be likely to insist on some appropriate standards of behavior from the collection agency and limits on their activities.

Moreover, default and many collections terms are set in the original contract between the consumer and originating creditor and are binding on the collections firm. As noted, this means that creditors will tend to restrain their demands for certain remedies and collection methods in order not to deter consumer demand for their product. In fact, studies conducted by the NCCF found that even though at that point collection terms in consumer contracts were lightly regulated by law (and thus largely subject to contract), creditors did not insist on dragnet-style remedies clauses that reserved every possible remedy available to the creditor at law. Instead, consumer contracts typically preserved only some of the remedies permitted by law. In general, the remedies that creditors preserved were those that were seen as both most effective by creditors at collecting the debt and also most fair by consumers. Moreover, creditors actually invoked only a subset of those remedies in practice. In short, creditors tended to rely on those remedies that had the highest marginal benefit at the lowest marginal cost, but which also were seen by borrowers as legitimate and fair. In addition, common law remedies for fraud and breach of contract also help to police improper behavior.

On the other hand, some creditors did insist on access to all remedies upon default and might have actually pursued those in practice. A primary focus of the laws and regulations enacted at the state and federal level during that period was to standardize the industry by outlawing some of these more arcane and unexpected practices that were outliers from consumer expectations and typical industry practices.[94] By standardizing the collection terms, eliminating unusual or surprise contract terms, and preserving those that were seen as effective by creditors and fair by consumers, many of the laws and regulations at the time were arguably economically efficient.

Thus, even in markets that seem ineffective at protecting consumers because consumers cannot choose their provider directly, consumers may nevertheless be protected indirectly by other market forces to at least some degree. Thus, although it is often implied that non-contractual consumer markets by definition will fail to protect consumers, that assumption is not correct. To

[94] Zywicki *Debt Collection*, *supra* note 39, and sources therein

be sure, the case for government regulation and enforcement is likely to be stronger in such markets, but there are nevertheless some market forces as well as common law remedies to protect consumers. Regulation can thus play an important role in supplementing markets and common law. Other approaches could also be useful to assist creditors to monitor their agents, such as industry self-regulation and certification.[95]

Credit reporting agencies raise similar issues from a consumer protection perspective. Credit reporting agencies receive information directly from creditors without the consumer's permission. As with debt collection, if a consumer were authorized to control their information, each individual consumer would permit only positive, not derogatory information, to credit bureaus. But the selective reporting of only positive information would dramatically reduce the information content of credit bureaus. On the other hand, credit bureaus do not have an incentive to collect only negative information, because reporting both positive and negative information on consumers provides more accurate information than reporting only negative information, simultaneously producing lower delinquency rates and an expansion in the number of loans made for a given pool of consumer applicants.[96] Thus, they have some incentive to provide a full and accurate picture to their customers.

But voluntary reporting by creditors can lead to errors on a consumer's file, which any particular creditor lacks the incentive to correct. This is especially problematic where the inaccuracy arises from stale information that has not been updated. Creditors have minimal incentives to update that information once the debt is either paid off or discharged. Consumers do have an incentive to monitor the accuracy of their credit reports as inaccuracies can result in paying more for credit or other harms, and the credit reporting system provides processes for consumers to do that. But challenging inaccuracies in one's credit report can be time-consuming and aggravating, and some consumers may not know how to pursue a correction, thus errors are likely to go uncorrected.

On the other hand, the credit reporting agencies have an incentive to be attentive to the accuracy of their reports in order to increase their value to creditors who purchase their services. Thus, they will not be entirely indifferent to errors in consumer reporting files. Although this to some

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95 See Maureen K. Olhausen, Remarks of FTC Commissioner Maureen K. Ohlhausen before the Direct Selling Education Foundation Self-Regulation and Consumer Protection Panel (Apr. 7, 2015). For example, the Receivables Management Association International operates a receivables management certification program to qualified debt buyers. See https://rmaintl.org/certification/; see also Reilly Dolan, Self-Regulation and Debt Buying, Federal Trade Commission, https://www.ftc.gov/news-events/blogs/business-blog/2015/08/self-regulation-debt-buying (Aug. 26, 2015).

96 *See* John M. Barron and Michael E. Staten, *The Value of Comprehensive Credit Reports: Lessons from the US Experience*, in Credit Reporting Systems and the International Economy (Margaret Miller ed., 2003).

extent aligns the incentives of the credit bureau with that of the consumer, it is an imperfect alignment. Credit reporting agencies will have an economic incentive to pursue greater accuracy only to the point at which the marginal benefit of greater accuracy with respect to an individual consumer is equal to the marginal cost. This is unlikely to be the same point that optimizes value to the individual consumer, who internalizes all the costs (and potentially benefits) of those inaccuracies. As a result, public agencies can play a role in crafting and implementing rules on credit rating agency practices that supplement their market incentives to pursue accuracy.

Thus, even when consumers lack direct ability to choose their provider of a service, markets, common law, and public agency regulation can still complement each other as part of a three-legged stool that can protect and empower consumers.

6.3 Regulation by Public Agencies

How should the CFPB think about executing its mission as part of the three-legged stool? This section discusses three elements of that question. First, it provides a framework for assessing when government intervention is appropriate. Second, it discusses contrasting approaches to regulation that have emerged, namely the difference between "market-replacing" and "market-reinforcing" regulation. Finally, this section analyzes the proper domain of consumer financial protection based on understanding consumer behavior.

6.3.1 What Is a Consumer Protection Issue?

As a threshold question it is necessary to first understand: what is a consumer protection issue? Consumer protection issues arise from contexts in which consumers make decisions that reduce their individual welfare and are not reasonably able to avoid that result, such as decisions made in the absence of competitive alternatives or as the result of deceptive or unfair practices.

This scenario can be distinguished from a different but superficially similar scenario, where consumers make decisions that are rational under the circumstances, but which appear to be irrational or welfare-reducing to third parties such as government regulators. Simply because a consumer bears a cost from a decision does not mean that on net, the consumer suffers harm from a *consumer protection* standpoint. Consumer protection harms typically flow from scenarios in which consumers do not understand the relative costs and benefits of a financial decision that they make because of fraud or some other interference with understanding. But in some scenarios the decision by a consumer is not the result of a failure to understand the costs and benefits but instead a rational response to those incentives given the constraints the consumer faces, which is distinct from a consumer protection harm. Because even a painful choice may be the best available option in the circumstances, pain alone does not necessarily indicate a consumer protection problem.

Consider the example of "rational default" on consumer loans. Multiple factors influence whether consumers will default on an extension of credit including large unexpected expenses or macroeconomic conditions that lead to default for reasons largely beyond consumers' control, such as job loss. But in some instances, consumers default not because they are is unable to repay the obligation but because they choose not to repay. In this latter situation, consumers' decisions to default may be "rational" in the sense that on net, the benefits of not paying the obligation exceed the costs of choosing not to pay, and default results from a rational response to incentives to default instead of paying the debt. Economists model the decision whether to default on a loan as an "option" contract, and predict that if the benefits of default increase or the costs of default decrease, consumers will be more likely to elect to default.

The concept of rational default is straightforward. Consider the decision whether to default on a standard 30-year mortgage.[97] Each month consumers have a choice—to make the monthly mortgage payment or choose not to make the monthly installment payment. The decision to make a payment in any given month is analogous to a "call" option in finance. By making the monthly payment installment, the borrower retains the option to eventually purchase the underlying asset (the home). If a consumer exercises this option for 360 consecutive months, at the end of that period she will own title to the asset free and clear. The decision to default, on the other hand, is analogous to a "put" option. The consumer can choose *not* to make the monthly payment and instead exercise the option to not buy the home and, eventually, to permit the lender to foreclose on the home and take possession and resell the collateral. Of course, consumers will decide whether to pay or default based on their subjective assessment of the benefits and costs of the alternative options. Nevertheless, the same basic model of rational default applies to any consumer loan, including credit cards, payday loans, or a payday loan. In this sense, economists model the default decision by consumers as not fundamentally different from that of a business or commercial enterprise.

The option theory of default suggests that consumers would be more likely to exercise their option to default when the benefits of doing so are high or the costs of doing so are low.[98] Appreciation in underlying home value increases the benefit to the homeowner of excising his

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[97] *See* Todd J. Zywicki and Gabriel Okloski, *The Housing Market Crash*, Mercatus Center Working Paper No. 09-35 (Sept. 2009), *available in* https://www.mercatus.org/publications/financial-markets/housing-market-crash.

[98] Id.

call option to retain ownership of the home (or alternatively to transfer it to someone else). By contrast, declining home values make it more valuable for consumers to exercise their put option and default on the mortgage. The incentive to default will be especially powerful when the mortgage is "underwater" or in a "negative equity" position, meaning that the home is worth less than the outstanding balance on the mortgage. Under the circumstances of negative equity, at the margin rational investors would be predicted to exercise their put option to default more readily than a homeowner in a positive equity position. Empirical studies have generally supported the theory of rational default as having explanatory power for many mortgage defaults.[99] For example, homeowners are less likely to default in areas of faster home price appreciation than in otherwise-similar areas with slower appreciation.[100] Numerous studies conducted during the financial crisis found that a major reason for the large number of foreclosures that occurred at that time was the dramatic drops in home values and large number of homeowners in a negative equity position who chose to default on their mortgages, even when they could pay.[101] As a result, one of the major precipitating causes of the foreclosure crisis was the deterioration of down payment requirements, both of which made it more likely that borrowers would fall into a negative equity position when housing prices later declined.[102]

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[99] Kerry D. Vandell, How Ruthless Is Mortgage Default? A Review and Synthesis of the Evidence, 6 J. Housing Res. 245 (1995); James B. Kau & Donald C. Keenan, An Overview of the Option-Theoretic Pricing of Mortgages, 6 J. Housing Res. 217 (1995); Patric H. Hendershott & Robert Van Order, Pricing Mortgages: An Interpretation of the Models and Results, 1 J. Fin. Services Res. 19 (1987).

[100] 1 Mark Doms, Frederick Furlong & John Krainer, *House Prices and Subprime Mortgaged Delinquencies* 1–2 (FRBSF ECON. LETTER NO. 2007-14, 2007); Brent W. Ambrose, Charles A. Capone, Jr. & Yongheng Deng, *Optimal Put Exercise: An Empirical Examination of Conditions for Mortgage Foreclosure*, 23 J. Real Est. Fin. & Econ. 213, 218 (2001) (finding higher default rates where home price appreciation slower); Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures* 2–3 (Fed. Res. Bank of Boston, Working Paper No. 07-15, 2008), available at http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf (concluding that dramatic rise in Massachusetts foreclosures in 2006-07 resulted from decline in house prices beginning in summer 2005); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, CRL Res. Reports at 1, 13 (Dec. 2006).

[101] "Strategic default" refers to the practice of intentionally defaulting on some obligations while continuing to pay others. During the financial crisis of 2008, for example, many consumers chose to default on their mortgages while continuing to pay their other loans, such as credit cards, student loans, and car loans. In most instances this was because their mortgage was in a negative equity position and so it was rational for them to stop paying on that asset. *See* Luigi Guiso, Paola Spienza, and Luigi Zingales, *The Determinants of Attitudes toward Strategic Default on Mortgages*, 68 J. of Finance 1473 (2013). It is also bears note that the propensity of consumers to strategically default was positively correlated with credit score, which suggests that sophisticated consumers were those who were most likely to see and act on the incentive to default. *See* Experian-Oliver Wyman Market Intelligence Report: Understanding Strategic Default In Mortgages, Part 1 (2009).

[102] Zywicki and Okloski, *supra* note 97; *see also* Yuliya Demyanyk and Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 24 Rev. of Fin. Stud. 1848 (20110.

Consumers are also more likely to exercise their option to default when the benefits of defaulting increase.[103] For example, in most states if a borrower defaults on her mortgage, the lender can not only repossess the collateral and sell and apply the value to the outstanding debt, the lender can also sue the borrower personally for any remaining deficiency. In some states, however, the lender is limited only to foreclosing on the home and cannot reach the borrower's personal assets. In such situations, the cost of default is much lower because the borrower can protect her personal assets. Empirical research has found that the presence of anti-deficiency laws (also referred to as non-recourse laws) can substantially increase the frequency of default and foreclosure, especially when housing prices fall (thereby providing the borrower with an incentive to walk away).[104] Most striking is that this incentive effect to default is greatest with respect to higher-value houses, which suggests that wealthier homeowners are most likely to benefit from anti-deficiency laws because those with more wealth to protect are more likely to respond to the incentives created by anti-deficiency laws .[105]

The theory of rational default, however, is not limited to mortgages; it applies to other consumer financial products as well. Consider payday loans. Payday loans have been noted for their high rate of "rollovers," which occur when consumers fail to pay their balance at the end of the loan term and instead "rollover" the loan for another period. There has been speculation that consumers are somehow "forced" to roll over their loans, perhaps because of fear of lawsuits, an adverse credit report, or debt collection.[106] This assumption grounds the theory that for some consumers, payday loans constitute a "debt trap" that they are unable to escape.[107]

But as the model of rational default indicates, decisions about whether to default, roll over, or pay off a loan depend on the relative benefits and costs of choosing each option.[108] Regarding default,

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103 *See* Zywicki and Okloski, *supra* note 97.

104 See Lawrence D. Jones, Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans, 36 J. L. & Econ. 115, 135 (1993).

105 *See* Andra C. Ghent and Marianna Kudlyak, *Recourse and Residential Mortgage Default: Evidence from US States*, 24 Rev. Fin. Studs. 3139 (2011).

106 *See* Bureau of Consumer Financial Protection, Payday, Vehicle Title, and Certain High-Cost Installment Loans, 12 CFR 1041 (Oct. 5, 2017) (hereinafter "2017 Small-Dollar Rulemaking").; *rescinded and replaced by* Consumer Financial Protection Bureau, Payday, Vehicle Title, and Certain High-Cost Installment Loans (Jul. 7, 2020).

107 Id.

108 See Todd Zywicki and Diego Zuluaga, Comment on the CFPB's Notice of Proposed Rulemaking on "Payday, Vehicle Title, and Certain High-Cost Installment Loans, Docket No. CFPB-2019-0006 (May 15, 2019), available in https://www.cato.org/sites/cato.org/files/pubs/pdf/zywicki-zuluaga-public-comment-5-15-19.pdf. Among the greatest benefits of choosing not to default is the preservation of the option by the borrower to acquire further short-term loans in future periods.

the 2017 Small-Dollar Loan Rule recognizes that payday lenders rarely sue delinquent customers and do not report them to credit bureaus, so those sanctions are unlikely to be significant costs default. Perhaps borrowers fear debt collection efforts, but what matters to consumers is the predicted costs of collection efforts, rather than the collection efforts that actually occur.[109]

Default rates on payday loans are high, which suggests that many payday loan borrowers perceive relatively low costs of defaulting. According to CFPB research, 27 percent of defaults occur without ever making a payment, and almost half of all defaults occur on the first or second loan.[110] This group of consumers apparently believes that the cost of default is smaller than the cost of not defaulting and do not even make a single payment before choosing to default. Indeed, the quick default suggests that many borrowers intended to default at the time they first obtained the loan and had no intention to repay.

What are the benefits of rolling over a loan rather than defaulting? One hypothesis is that these consumers turn to payday loans because they have limited alternative credit options available to them.[111] Payday loans offer a last lifeline of access to credit for many pinched consumers. In the event of default, those borrowers will lose access to future payday loans from that same lender or perhaps other payday lenders. Thus, even if the direct adverse consequences from default are low, exercising the option to roll over the loan to preserve future access to payday loans might appear to be the best choice. If this is a primary reason why consumers rollover short-term loans, is not clear why the decision to exercise one's option to rollover the loan in order to maintain access to future credit is best explained as a conceptual model as a "trap." On the other hand, if the adverse consequences of default are high and unexpected for consumers, then that would provide support for framing these consumer decisions as raising consumer protection problems.

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[109] In the 2017 version of the small-dollar loan rule, the CFPB identified to the relatively large number of complaints registered by payday loan consumers against debt collectors compared to providers of other products as evidence that the threat of aggressive debt collection efforts might induce borrowers to roll over their loans instead of defaulting. From the perspective of determining whether a consumer is caught in a "debt trap" where he or she feels forced to perform instead of breaching, the aggressiveness of collection efforts *ex post* is relevant only to understanding the incentives for whether to perform *ex ante*. Analogously, in the economic theory of crime, the measurement of the deterrent effect of criminal sanctions is the number of people who obey the law and the amount of criminal activity that does not occur, not the frequency or severity of punishment after the fact. *See also* Gary S. Becker, *Crime and Punishment:An Economic Approach*, 76 J. Pol. Econ. 169 (1968).

[110] Consumer Financial Protection Bureau, CFPB Data Point: Payday Lending 27 (March 2014). Almost half of defaults occur on the first or second loan. *See id.* at 28; *see also* Susanna Montezemolo and Sarah Wolff, Center for Responsible Lending, Payday Mayday: Visible and Invisible Payday Lending Defaults (March 2015).

[111] *See* discussion in Chapter 5 of the characteristics of payday loan borrowers, including their limited access to alternative credit products.

As this extended example of rational default indicates, when consumers are informed about the costs and benefits of making a choice and respond to those incentives by making the cost-minimizing choice, it is not obvious why this creates a consumer protection problem calling for government intervention. Before the CFPB or any other regulatory agency intervenes in a market, it should first establish that there is indeed a market failure that causes a consumer protection problem. It should accurately define the nature of the problem and the causal connection between the market failure, the harm it causes, and the proffered solution.

The Taskforce has been able to locate no evidence to estimate the benefits and costs to consumers of performing on their payday loan contracts instead of defaulting. It is possible that a threat of lawsuits, adverse credit reporting, or aggressive debt collection practices induce some consumers to roll over their loans. There are clear benefits to consumers from being afforded the option to extend the deadline for repayment of short-term loans, even where there is some cost associated with exercising that option. Thus, a consumer's decision whether to roll over a payday loan might reflect a rational calculation that the marginal benefits of retaining the option of keeping the loan balance outstanding for another term exceed the marginal costs of doing so, even if the cost of default is relatively small.[112] The Taskforce recommends that the CFPB conduct research to better understand why consumers choose to roll over payday loans. Similar research should be conducted for other products under the CFPB's jurisdiction where relevant, to determine whether consumer choices reflect rational responses to existing incentives or some consumer protection problem.

Correctly identifying the source of observed behaviors is crucial not only for properly identifying the presence and nature of the consumer protection problem but also to avoid unintended consequences that could harm consumers a regulation is intended to help. Most important, if a particular behavior results from consumers' responses to incentives and not fraud or some other feature that interferes with understanding, then treating the behavior as resulting from a consumer protection issue could actually exacerbate the problem. For example, although many consumers were victims of fraudulent lending practices that eventually resulted in foreclosure, many other borrowers chose to default strategically, when their homes fell in value and became worth less than was owed on the mortgage. Thus, the presence of anti-deficiency laws for residential mortgages in some states, which reduced the costs of default and increased the benefits, contributed to the severity of the 2008 foreclosure crisis by providing incentives for homeowners to default on their mortgages when home prices fell, especially among those who

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[112] *See* Kevin W. Caves and Hal J. Singer, "Re: Docket No. CFPB-2016-0025/RIN 3170-AA40," Economists Inc. (Oct. 7, 2016).

buy homes for investment purposes or second homes. Yet the Dodd-Frank Act provides specific statutory protections to ensure that more homeowners preserve their anti-deficiency rights under state law where relevant.[113] As a result, this provision will likely have the effect of *increasing* foreclosures during a future financial crisis that resembles the last one where property values fall. Thus, the failure to appreciate the logic of how consumers respond to incentives could ironically exacerbate the problem that the legislation was intended to address.

6.3.2 Market Failure and Government Intervention

Not every decision by a consumer necessarily results from a market failure, and not every market failure that could reduce consumer welfare raises a consumer protection problem. Before intervening in a market, the government should take care to determine the extent of any consumer harm, the causes of that harm, and that any proposed intervention will actually improve outcomes for consumers. Although regulation and enforcement by public agencies can be uniquely valuable in protecting consumers when other institutions cannot, public action also raises unique concerns. In particular, private market activity and common law can be relatively nuanced and tailored to the preferences of buyers and sellers of financial products or any consumer product. Regulation often displaces voluntary transactions between consumers and providers that are generally presumed to be mutually beneficial. Moreover, the vast reach of regulatory authority and its ability to cover broadly across the market raises concerns about influence by outside special interests and the internal biases of regulatory agencies themselves can lead to regulation that fails to advance overall consumer welfare.

These tradeoffs suggest that before intervening, an agency should conduct a three-step analysis and ask:

1. Is there a market failure?

2. Is there a feasible solution to address the market failure?

3. Will the benefits of the proposed intervention exceed the costs, including all unintended consequences associated with the intervention?

As this analysis makes clear, not all market failures can and should be the subject of regulatory intervention. Regulators should intervene only where market failures can be corrected with benefits exceeding the costs of doing so.

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[113] *See* Dodd-Frank §1414 ("Protection Against Loss of Anti-Deficiency Provision").

Determine the Presence and Nature of the Market Failure

First, the nature of the market failure must be identified accurately in order to propose a useful remedy. In general, economists have identified four categories of potential market failure that are relevant to the current discussion: (1) Asymmetric information, (2) Externalities, (3) Market or monopoly power, and (4) Public Goods. In the world of consumer financial protection, the primary source of market failure is asymmetric information, i.e., where the provider of a product or service has more information about the product and its terms or attributes than does the consumer. The terms and attributes of many consumer financial products are irreducibly complex, which reflects the complex and varied uses of these products by consumers. Credit cards, for example, contain numerous different features and attributes that reflect the varied uses of these products by consumers, such as annual fee, interest rate, benefits, credit line, and many other prices for various services such as cash-advance fees, late fees, etc. By contrast, payday loans are formally relatively simple products, typically featuring one basic price—the periodic finance charge—with perhaps a few other terms. Since the 1970s, the most common concern about market failure in consumer finance markets has been asymmetric information, which has been addressed primarily with information-based remedies.

Usury laws provide an example of substantive regulation. Consumer financial protection in the United States was traditionally provided at the state level, which was ordered around the idea of substantive regulation by the government of the terms and prices of consumer credit products. Usury ceilings, at root, rested on the idea that a consumer should not be permitted to pay above a certain price for any consumer loan, even if fully informed about its price and even if the consumer thought it was in their personal welfare to use the product.[114] As a result, the allowable interest rate on consumer loans was capped by law, even if the equilibrium market-clearing price was not, so that consumers ended up paying essentially the same overall effective price.

Beginning in the 1970s, consumer financial protection regulation began to migrate away from substantive regulation of terms and prices that mandated regulatory-imposed product design. This new approach made providers and consumers the primary architects of product design through voluntary market interactions instead of government regulators. For example, as discussed in Chapter 10, deregulation of interest rates on credit cards enabled greater variety in

[114] Oddly, this mindset about consumer financial products did not then and does not now carry over to other consumer purchases. For example, although usury ceilings might limit the price that could be charged on a car loan, there is no similar price cap on the price of the actual car, even though overpaying for a car might cost a consumer far more money overall than an interest rate that exceeded the statutory cap. As noted above, the NCCF also made this observation in its Report and noted that it was unable to discern any reason why the maximum price of credit should be set by law but not the price of hamburgers or other consumer goods.

offerings to consumers, as banks based in some states could offer cards with higher interest rates and no annual fee, while others were forced to offer cards with an annual fee but lower interest rate capped by regulation. As noted above, this evolution in regulatory strategy arose in response to the growing consensus that substantive regulation such as usury ceilings were ineffective at best at protecting consumers and counterproductive at worst.

These developments in economic understanding were matched by societal changes during that era that eliminated many of the paternalistic attitudes and stereotypes that animated many of these traditional regulations. Most notable, women as a group historically were seen as less-capable of managing finances than men, a stereotype that rested on the longstanding assumption that women had poor math skills compared to men and that therefore aggressive retailers would goad them into unnecessary purchases and heavy debt.[115] Paternalistic restrictions on low-income consumers' ability to access credit rested on similar unfounded negative stereotypes about their alleged lack of mental acuity and impulse control, often mixed with a large dose of negative implied racial stereotyping as well.[116]

This should not be read to deny the reality that there are certain groups of consumers who are indeed vulnerable cognitively or in some other fashion, such as elderly Americans who suffer from cognitive decline as they age or others who are unable to protect themselves. But in a free society and free economy, there should be a starting presumption that adult consumers are autonomous actors who typically know better than governmental actors what challenges and opportunities they face and how to best meet their family's needs with the actual choices that are available to them at the time and under the constraints they face. Before government intervenes, especially in a substantive fashion, there must be some reason to believe that the market failure is of the type that can be remedied best by replacing the outcome of consumer choice and competition with government mandate and not by less-intrusive measures, such as market responses or common law remedies.

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[115] Lendol Calder, Financing the American Dream: A Cultural History of Consumer Credit 166 (2001) (noting that installment sellers in earlier generations were criticized by consumer advocates for taking advantage of supposedly vulnerable groups such as "math-impaired females).

[116] *See* David Caplovitz, *Consumer Credit in the Affluent Society*, 33 L. and Contemporary Problems 641, 647 (1968) (asserting without evidence that low-income consumers were lured into taking on excessive debt to engage in consumption, a "deviant system" that "rests in part upon the ignorance of low-income consumers and their vulnerability to fast-talking salesmen," to which middle class families are immune). *But see* Theodore W. Schultz, *Nobel Lecture: The Economics of Being Poor*, 88 J. Pol. Econ. 639, 649 (1980) (concluding "poor people are no less concerned about improving their lot and that of their children than those of us who have incomparably greater advantages. Nor are they any less competent in obtaining the maximum benefit from their limited resources"); *see also* Jan M. Newton, *Economic Rationality of the Poor*, 36 Human Organization 50, 58 (1977) (concluding that "low income consumers are rational satisfaction maximizers and that they share the basic values and goals of other, more affluent Americans").

Identify a Proposed Remedy That Responds to a Market Failure

Second, there must be a realistic potential government remedy that addresses the identified market failure. Market failures arising from incomplete or asymmetric information that are not addressed through market solutions, such as advertising, money-back guarantees, or credible third-party verification firms, would be suitable for information remedies, such as required standardized disclosures. Market failures that are believed to flow from non-informational factors, such as alleged cognitive or self-control limits, "externalities," or market power, are potential subjects for substantive regulation to restructure incentives, or outlaw or limit particular products or practices. Additional information is unlikely to prove effective at changing the consumer's choice under those circumstances, as the harm in question arises from forces such as misaligned incentives (in the case of externalities, for example), market power (where the consumer might be fully aware that the price exceeds the competitive price but is unable to effectively do anything about it), or cognitive limitations (that interfere with the ability of consumers to fully comprehend and appreciate the information that they are provided).

Moreover, requiring additional information to be provided might actually be counterproductive from the perspective of the consumer by increasing their confusion and making more difficult to find what information they actually care about. For example, as discussed in Chapter 7 of this Report, providing information that consumers do not actually value as part of their shopping behavior, but which regulators think consumers *should* value, can distract their attention from important terms that they actually do care about and consider relevant, which can be characterized as "normative disclosure."[117] In turn, by distracting consumers to focus on the information that regulators believe most important, at the expense of information that consumers consider most important, can lead consumers to make inferior choices than they would have without the additional information.

These two alternative approaches to regulation have been labeled "market-reinforcing" and "market-replacing" regulation.[118] Market-reinforcing regulation refers to regulatory action designed to "promote competition and consumer choice so that consumers can find those

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[117] *See* discussion in Chapter 7; *see also See* Todd J. Zywicki, *The Market for Information and Credit Card Regulation*, 28 Banking and Fin. Servs. Report 13 (2009).

[118] *See* Todd J. Zywicki, *Market-Reinforcing versus Market-Replacing Consumer Finance Regulation*, *in* Reframing Financial Regulation: Enhancing Stability and Protecting Consumers 319 (Hester Peirce and Benjamin Klutsey, eds., 2016); *see also* Brian Johnson, *Deputy Director Johnson's Speech at CFPB Symposium on Behavioral Economics* (Sept. 19, 2019), *available in* https://www.consumerfinance.gov/about-us/newsroom/deputy-director-johnsons-speech-cfpb-symposium-behavioral-economics/ (describing these two approaches to regulation).

products that they think are best for themselves and their families."[119] Market-reinforcing regulation is consistent with the disclosure-based regulatory strategy of the past several decades that is designed to help markets function and to satisfy consumer demand more effectively by enabling consumers to shop more easily among competing product providers. It also includes vigorous prosecution of fraud, deception, and other unlawful practices that undermine consumer choice.[120]

By contrast, market-replacing regulation displaces consumer choice and seeks to limit competition and consumer choice "through prohibitions or restrictions on particular products and terms, such as price controls on interest rates (known as usury regulation) or de facto or de jure bans on particular products such as payday loans or bank deposit advance products."[121] Market-replacing regulation reflects decisions by legislators or regulators to supplant the terms for which "the parties would voluntarily bargain with terms dictated by the regulators, and to prohibit consumers from entering into certain contracts even if those consumers believe that purchasing that product furthers their own goals."[122]

The Benefits of the Proposed Intervention Should Exceed the Costs

After first determining whether a market failure exists and considering any feasible regulatory responses to that market failure, the final step before taking regulatory intervention should be to determine whether the benefits of any proposed intervention exceed the costs of the intervention, including the costs of any foreseeable and predictable unintended consequences that result from the intervention. The Dodd-Frank Act itself requires the CFPB to undertake cost-benefit analysis in determining whether to issue a rule, noting that in issuing a rule the Bureau "shall consider— the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule."[123] Potential costs of intervention should include not only direct costs, such as increases in costs from regulatory compliance that will be passed through to consumers as higher prices and reduced access. But there are additional indirect costs to consumers that result from decreased

[119] Zywicki, *Market-Reinforcing*, *supra* note 118, at 321.

[120] Johnson, Deputy Director Johnson's Speech, supra note, 118.

[121] Zywicki, *Market-Reinforcing*, *supra* note 118, at 320-21.

[122] Zywicki, *Market-Reinforcing*, *supra* note 118, at 321. Market-replacing regulation has also been called "command-and-control" regulation as it reflects a decision by the regulator to dictate the design of product features. *See* Johnson, *supra* note 37.

[123] 12 U.S.C. §5512(b)(2).

choice, innovation, competition, access and inclusion. This Report returns to this theme in Chapter 13 in discussing how to apply cost-benefit analysis to proposed regulatory interventions. A few words are in order here, however.

As discussed above and in Chapter 5, one effect of regulatory intervention can be to reduce consumer choice and deprive consumers of more-preferred products forcing them toward greater use of less-preferred products. Consumer choice and behavior reflect a "pecking order" or ladder of consumer financial products. Losing access to a more preferred type of credit, such as credit cards, tends to lead consumers to substitute to less preferred (and usually more expensive) products, such as payday loans or pawnbrokers. In addition, as discussed in Chapter 5, demand for these products tends to be relatively inelastic, supply costs tend to be high, and pricing tends to be relatively uniform with limited pricing margins, making it difficult for relatively lower-risk consumers to gain lower prices than relatively higher-risk borrowers. The foreseeable consequences of the costs of product substitution, therefore, will not only be the direct cost that results from forcing consumers to rely on more-expensive types of credit but also the cost associated with reducing their overall access to credit.

As discussed in Chapter 8, one recurring cost of the structure of regulatory intervention historically has been the adverse effect on competition from creating barriers to entry, regulatory-imposed segmentation of markets among product providers, and other rules that create market power for dominant firms locally or provide competitive advantages for certain providers of consumer financial products relative to others. For example, one important effect of historic state usury regulations has been to limit the effective range of choice for consumers by promoting competition on the margin of the comparative ability of different types of product providers to circumvent the distorting effects of price controls on interest rates, instead of competing directly on price and quality. For example, as discussed in Chapter 10, the dominant position held by retailers in credit provision for many decades reflected the preferential regulatory status they held compared to banks and other financial service providers under the "time-price doctrine" and the ability to offset below-market pricing for credit by raising the price of appliances and other goods typically purchased on credit. This circumvention activity reduced price transparency in markets for both goods and credit as well as limiting consumer choice in credit providers to department stores and other large merchants. With respect to credit card issuers, usury ceilings led to the imposition of annual fees, which were not only economically regressive in their impact but also acted as an effective tax on card-holding by consumers, thereby dampening competition and increasing switching costs by consumers. Where regulation has the effect of dampening competition and creating regulatory-induced increased market power it is predictable that any price increase or decline in supply will be larger than would otherwise be the case.[124]

Finally, a full accounting of costs should include the costs associated with rationing access to credit. Some of these costs, such as the long-standing and reoccurring presence of illegal loan sharks, are difficult to quantify, but the economic and human tolls are unquestionably high. But to this list of costs that result from rationing should also be included the costs of foregone valuable investments, such as the costs associated with being unable to buy or repair important household appliances (such as a clothes washing machine) or reliable automobile transportation. Regulators traditionally have not tried to include those opportunity costs in their overall calculations of the relative costs and benefits of regulation, but a full accounting suggests that they should.

A final factor for regulators to consider is in choosing between market-replacing (i.e., substantive regulation of terms and products) and market-reinforcing rules (such as disclosure rules).[125] Market-replacing rules, in general, can be expected to impose higher costs on providers and consumers than market reinforcing rules. This is because, by definition, market-replacing rules foreclose consumers and providers from entering into voluntary transactions that they desire to enter into. Moreover, regulators face much higher information costs before enacting market-replacing rules because of the likelihood that their unintended costs will be higher than for market-reinforcing rules. Market-reinforcing rules, by contrast, seek to facilitate consumer choice and to enable consumers to find the products and services that they desire, rather than supplanting consumer choice with the preferences of regulators. Thus, even if the new rule increases the costs to certain consumers of contracting for the products and services they desire, they are not foreclosed from doing so by regulatory mandates. Thus, although market-replacing rules might nevertheless have benefits that exceed their costs, the higher costs associated with those rules suggests that before enacting such rules, regulators should ensure that the proposed rule has substantial benefits that cannot be accomplished or approximated with a more modest rule (such as a disclosure requirement) or no rule at all. On the other hand, where consumer harm cannot be mitigated at reasonable cost through market-reinforcing rules, market-replacing rules might be appropriate. For example, many scholars have criticized the proliferation of

[124] *See* Zywicki and Zuluaga, *supra* note 108.

[125] *See* Zywicki, *supra* note 118.

disclosures in consumer financial regulation to the degree where they can overwhelm consumers and can be counterproductive to consumer understanding.[126]

On the other hand, one possible explanation for the explosion in mandatory disclosures may be the recognition by regulators of the high costs and unintended consequences that can accompany substantive rules. This, in turn, has reduced the effectiveness and increased the costs to consumers of dealing with an excessive number of disclosures. As discussed in Chapter 7, regulators should be careful before loading on additional disclosures, in light of the many disclosures that consumers already face when trying to use any financial product.

6.4 Regulatory Tools

A final challenge for a regulatory agency is the appropriate use of their regulatory tools. When the agency decides that there are some feasible actions it could take that are projected to have benefits that exceed the costs, the agency must determine which of its various tools, alone or in combination, are best suited to the task.

The CFPB is unusual in the large variety of tools that it has at its disposal. As outlined in Dodd-Frank §1021(c), CFPB has five distinct sets of "functions" or regulatory "tools": (1) Regulation, (2) Enforcement, (3) Supervision, (4) Consumer Education, and (5) Policy Research and Development.[127] In addition, the CFPB also uses various informal tools, such as supervision and enforcement guidance, policy statements, and No-Action Letters, which are not so much independent regulatory tools but which help to implement those other tools. As far as the Taskforce is aware, few regulatory consumer protection regulatory agencies in the world possess such a wide variety of tools at their disposal in one agency. The FTC, for example, lacks the supervision authority that the CFPB possesses and must follow complex procedures to exercise its general rule-making authority. Most state attorneys general offices, which are the primary state authorities with respect to implementing state consumer protection laws, possess primarily enforcement powers, with limited research capacity (especially economic research) and consumer education, and virtually no regulatory or supervisory authority, which are left to state regulatory agencies or others.

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[126] *See* discussion in chapter 7.

[127] 12 U.S.C. §5511(c).

This unique combination of five tools in one consumer protection agency creates both an opportunity and a challenge for the CFPB. It is an opportunity in that the CFPB can more carefully calibrate the best tool for an identified regulatory task, rather than being forced to jerry-rig an existing limited set of tools to address a problem, such as using enforcement to address problems perhaps better resolved through supervision or rulemaking. On the other hand, possessing several tools that could all be brought to bear on the same question raises the danger of duplicative and inconsistent regulation by different offices within the same regulatory agency. This danger, in turn, highlights the need for diligence and persistence to ensure that various divisions wielding different tools are well-coordinated and exercise self-restraint in trying to bring their particular tools to bear on a particular topic.

Reviewing the CFPB's history, it is unclear what its vision and strategy have been and how to determine which tools are best suited to address particular types of problems. This lack of strategic planning has in some instances resulted in a lack of coherence and consistency across the agency in implementing some of its rules and regulations. Testimony at the CFPB's Symposium on "Abusive Acts or Practices" contended that the CFPB has applied inconsistent definitions of the term "abusive acts or practices" from different divisions of the agency, such as enforcement, rulemaking, and supervision.[128] For example, the interpretation of "abusive acts or practices" applied in the 2017 Small-Dollar Loan Rulemaking shows little similarity to the CFPB's use of the term in its enforcement actions.[129] Although supervisory oversight is necessarily confidential, the CFPB had provided very little information about how "abusive" would be interpreted and applied in that context, largely simply restating the language of the Dodd-Frank Act with minimal additional elaboration.[130] As a result, although each of these three tools can lay claim to being tailored to implement the "abusiveness" standard in a particular context, the fact that the CFPB possess all three of these powerful tools raises the risk of inconsistent or multiple mandates that produce costs that outweigh the benefits of regulation. The Taskforce commends the CFPB for adopting its policy statement to clarify its approach to abusive acts and practices. Nevertheless, it remains unclear to what extent the CFPB will follow the policy statement in practice.

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[128] Statement of Todd Zywicki, Prepared for Consumer Financial Protection Bureau Abusive Acts or Practices Symposium (June 25, 2019), *available in* https://files.consumerfinance.gov/f/documents/cfpb_zywicki-written-statement_symposium-abusive.pdf.

[129] *See* Bureau of Consumer Financial Protection, "Statement of Policy Regarding Prohibition on Abusive Acts or Practices,' Billing Code: 4810-AM-P (January 21, 2020), *available in* https://files.consumerfinance.gov/f/documents/cfpb_abusiveness-enforcement-policy_statement.pdf.

[130] Id.

In addition, the lack of a clearly articulated strategy for tool usage has led the agency in some instances arguably to use the "wrong" tool for a particular job. Examples are provided below.

6.4.1 Regulation

Regulation is arguably the most extensive and far-reaching power possessed by the CFPB.[131] The Dodd-Frank Act specifically mandated that the CFPB issue rules on particular subjects. The CFPB is also prohibited from issuing any rule establishing a "usury limit" for the extension of credit.[132] Beyond those limits, the CFPB has discretionary rule-making authority with respect to rules to implement any of its enumerated statutory authorities as well as to regulate unfair, deceptive, and abusive acts and practices. Several of the rules issued by the CFPB were required by the Dodd-Frank Act, and others were discretionary.

Regulation generally can be characterized as coming in two different forms, principles-based regulation versus rules-based regulation. Principles-based regulation rests on a set of principles of conduct and outcomes, but which then largely leaves the regulated parties and their enforcement agencies to decide how to most appropriately implement them. As summarized by Chairman of the Commodities Futures Trading Commission Heath Tarbert, "In general terms, principles-based regulation reflects a transition away from detailed, prescriptive rules toward high-level, broadly-stated principles that create standards by which regulated firms must operate. Under this approach, firms are responsible for finding the most efficient way of achieving regulatory objectives."[133] Tarbert notes that principles-based regulation aims at the same objectives as rules-based regulation, "It simply does so in a way that is often more efficient and less burdensome than rules-based regulation, leaving space for flexibility and innovation."[134] CFPB's authority to prohibit "unfair, deceptive, and abusive" acts and practices is an example of principles-based regulation, in that it provides a framework of proscribed behaviors that are defined with respect to the harm that those practices cause to consumers.

Federal consumer protection law historically has reflected principles-based regulation, most notably the FTC's historic power to enforce prohibitions on "unfair or deceptive" acts or

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[131] *See* 12 U.S.C. §5511(c)(5) (authorizing CFPB to issue "rules, orders, and guidance implementing Federal consumer financial law"); §12 U.S.C. §5512(b).

[132] *See* 12 U.S.C. §5517(o).

[133] Heath P. Tarbert, Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation, 10 Harv. Bus. L. Rev. 1, 5 (2020).

[134] *Id.* at 6.

practices. Although those terms appear to be vague and uncertain, the FTC has refined their scope and meaning over many decades of enforcement and other activities that have updated and amended those terms in a common law fashion to suit emerging threats to consumers.

Rules-based regulation, by contrast, is highly prescriptive and typically provides not only detailed requirements but details the means to accomplish them as well, even if alternative less-expensive and more-effective means might be available. The long, detailed prescriptive menu of mandatory disclosures, both in content and format, required by the TILA, Real Estate Settlement Procedures Act, and other similar requirements exemplify the dominance of rules-based approaches over the last several decades. As the example of prohibiting "unfair" acts and practices on one hand compared to prescriptive mandatory disclosure on the other, the CFPB's status as a financial consumer protection regulator sits at an conceptual crossroads between the FTC's principles-based tradition of consumer protection and the banking regulators' rules-based approach to financial regulation.

CFPB's status as both a financial regulator and consumer protection regulator presents the challenge of integrating these two disparate approaches into a coherent regulatory approach. This challenge is exacerbated by the diversity of the industries that CFPB regulates. Banks and credit unions traditionally have been regulated primarily through a rules-based approach, and their prudential regulators also often tend toward that approach. Debt collectors and small-dollar lenders, by contrast, were traditionally regulated by the FTC and state attorneys general, which tended toward a somewhat more principles-based approach focused on unfair and deceptive practices. Because the CFPB regulates both types of institutions, it has tended to draw fire from both sides, as banks have sought greater specificity in their obligations via rules-based regulation, while participants in other industries have complained of the undue complexity and regulatory burden of detailed rules-based regulations, which they contend stifles their ability to serve their heterogeneous customer base effectively.

A principles-based approach to regulation offers the potential for substantial benefits compared to traditional rules-based financial regulation. First, principles-based regulation has a greater degree of flexibility and adaptiveness to technological and social change that is more difficult with rules-based regulation. Rules-based regulation, by contrast, runs the risk of quickly becoming obsolete in response to changes in technology, the economy, or consumer preferences. Updating and amending rules-based regulation is an expensive and time-consuming process. Principles-based regulation also can also reduce regulatory cost by offering multiple pathways to the accomplishment of the same regulatory end and otherwise permitting regulated parties to search for the most-efficient and effective way of attaining the desired end.[135] Rules-based regulation also requires much higher levels of regulator knowledge to be effective, both as to the technological and economic factors that impact the rule but also regarding the most effective fit between the end goal and the means chosen to accomplish it.

On the other hand, principles-based regulation can create anxiety and uncertainty for the regulated community, especially for financial institutions long accustomed to more prescriptive regulation. This anxiety might especially be the case where the principles-based regulations are backed by the threat of enforcement with substantial potential penalties attached. Principles-based regulation can also create uncertainty when regulated entities are subject to civil liability, because multiple enforcers may apply the principles differently. Poorly designed and implemented principles-based regulation can create a chilling effect as regulated parties avoid the general zone of uncertainty that is created by the principles-based regulation. In doing so, the provider may eschew consumer-benefiting activities. Regulatory uncertainty could be especially counterproductive if those most impacted by the deterrent effect are higher-risk consumers who often benefit most from new innovations.[136] Principles-based regulation can also be problematic in the hands of an agency, such as the CFPB, which possesses a wide range of regulatory tools (regulation, enforcement, and supervision) and which is organized internally around those tools. The lack of precision provided by principles-based regulation (as opposed to rules-based regulation) can result in conflicting regulatory interpretations emanating from different offices of the agency. The example discussed above regarding the CFPB's seemingly inconsistent definitions of the term "abusive" when used in the context of regulation versus the context of enforcement illustrates the challenge of making principles-based regulation coherent across the agency. Lack of predictability with respect to principles-based regulation can be especially challenging in the context of CFPB rulemaking, as the Dodd-Frank Act authorizes state attorneys general under certain circumstances to enforce CFPB regulations and to pursue the expansive remedies provided by the Dodd-Frank Act. Thus, the principles may be applied in multiple fora, leading to the potential for inconsistent application. This inability to exercise tight control over the enforcement of CFPB rules could deter rulemaking where it might otherwise be optimal and lead the CFPB to use more informal guidance and the like.

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[135] The debate between the use of "performance standards" or "design standards" in regulatory theory is a subset of the debate over principles-based versus rule-based regulation. *See* Laura Montgomery, Patrick A. McLaughlin, Tyler Richards, & Mark Febrizio, *Performance Standards vs. Design Standards: Facilitating a Shift toward Best Practices*, Mercatus Center Working Paper (2019).

[136] *See* discussion at *supra* note 36 and accompanying text (discussing tradeoff between Type-I and Type –II errors).

The CFPB has in some instances engaged in rulemakings that contain unusually detailed and specific rules-based mandates and restrictions. For example, in its 2017 Small-Dollar Loan Rulemaking, the CFPB not only required that payday lenders and auto title lenders determine that certain borrowers in certain circumstances have the "ability to repay" their loans before issuing them credit, the CFPB actually went further and dictated to the industry specific underwriting and ability to repay models that they essentially were required to use to make that determination.[137] Principles-based regulation, by contrast, could have permitted the regulated parties greater flexibility to apply their own underwriting model to reach the desired goal.[138] This decision to mandate not just an outcome but a particular underwriting model illustrates the high information costs needed for rules-based regulation to be effective.

Although rules-based regulation has its virtues and has long-dominated the financial regulation sector, the accelerating speed at which technology, society, and the economy are changing is increasingly incompatible with the detailed and inflexible nature of rules-based regulations. Moreover, as the mandates and requirements of the regulatory state have become increasingly dense and complex, even the primary purported virtue of rules-based regulation—their apparent clarity and predictability—has become less valuable because of possible competing mandates and high compliance costs. Moreover, even if rules-based regulation increases predictability in the short-run, the constant need for updating those rules in response to external technological, market, and social changes increases unpredictability across time.[139]

The sentiment of the Taskforce is that the CFPB should, in general, direct its attention to greater use of principles-based regulation instead of rules-based regulation. In general, the CFPB should use its rulemaking power to provide a framework to be used in cooperation with its other tools, instead of viewing regulation as a single comprehensive final statement of its position on an

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[137] A distinct question is whether the primary reason for a particular borrower's default on payday loans reflects the borrower's inability to repay the loan or a decision to rationally default and whether prescribing an ability-to-repay test would materially impact the default rate.

[138] To be sure, monitoring default rates might also have adverse consequences for consumers if it encourages lenders to be more aggressive in collections in order to reduce their default rates.

[139] *See* Bruno Leoni, Freedom and the Law (expanded 3rd ed., 1991). This uncertainty historically has been heightened in the case of the CFPB by its unique single-director structure and limited Congressional oversight, which tends to amplify swings from one Director to another, unlike agencies with multi-member commission structures, which tend to promote greater stability and more dampened swings in policy. *See* Zywicki, *Savior*, *supra* note 31. The decision by the United States Supreme Court in *Seila Law v. Consumer Financial Protection Bureau*, 591 U.S. __, 140 S. Ct. 2183 (2020) that held that the Director of the Bureau is removable at the will of the President will likely amplify this tendency for large and more frequent swings in policy. *See* Stearns, Micelli, and Zywicki, *supra* note 69, at 734-750 (discussing dynamics of two-stage elections and implications for regulatory policy over time).

issue.[140] Where appropriate, it may also combine principles-based rules with safe harbors to provide greater regulatory certainty for particular practices. The CFPB should be conscious of avoiding the production of overly detailed and overly prescriptive rules that constrict flexibility. Overly-prescriptive rules also quickly become obsolete and require chronic updating, producing cost and uncertainty.[141] Within this broad framework, enforcement can be seen as a primary tool of clarifying the application of those principles to specific fact situations and updating the applicability of those principles in light of technological, social, and economic change.

At the same time, the Taskforce recognizes that by potentially creating uncertainty for the regulated community, increased use of principles-based regulation can have costs for consumers as well. As a result, the Taskforce encourages the CFPB to be proactive in providing guidance, policy statements, and other informal and flexible means to reduce the uncertainty to the regulated community.[142] In this vein, the Taskforce recognizes the many valuable initiatives that the CFPB has undertaken to reduce regulatory uncertainty. For example, in June 2020, the CFPB launched a Pilot Advisory Opinion program designed to increase the predictability of the CFPB's regulatory posture.[143] Through its Office of Innovation, the CFPB has developed a No-Action Letter Program that is available to clarify the CFPB's enforcement posture with respect to certain acts and practices, particularly designed to encourage innovation designed to improve consumer welfare. In January 2020, the CFPB issued a policy statement "Regarding Prohibition on Abusive Acts or Practices."[144]

An additional potential mechanism for reducing uncertainty would be greater use of regulatory "safe harbors." Although the Taskforce recognizes the potential value of safe harbors in theory, the Taskforce is also wary of their overuse in practice. It is difficult to define the scope of a safe

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[140] For example, the Safeguards Rule of the FTC and the similar rules of the prudential regulators required covered entities to take steps that are reasonable in the circumstances to address security risks. Whether a particular step is necessary in a given set of circumstances must be resolved through enforcement or, in the case of the prudential regulators, supervision.

[141] The Taskforce's recommendations on the E-Sign statute illustrate the dangers of prescriptive rules that can lock-in prescriptive rules and impose unnecessary costs on consumers and industry.

[142] *See* Tarbert, *supra* note 134, at 6 ("Principles can be fleshed out by rules or other forms of guidance (both formal and informal) as appropriate).

[143] Bureau of Consumer Financial Protection, "Advisory Opinion Pilot" (June 16, 2020), *available in* https://files.consumerfinance.gov/f/documents/cfpb_advisory-opinions-pilot_fr-notice.pdf.

[144] *See* Bureau of Consumer Financial Protection, "Statement of Policy Regarding Prohibition on Abusive Acts or Practices" (January 21, 2020), *available in* https://files.consumerfinance.gov/f/documents/cfpb_abusiveness-enforcement-policy_statement.pdf. As noted in the summary, the Statement was adopted "to convey and foster greater certainty about the meaning of abusiveness."

harbor in a principles-based fashion instead of an *ad hoc*, somewhat arbitrary carve-out. Because of their often arbitrary and unprincipled nature, *ad hoc* safe harbors can reflect the successful lobbying efforts of influential special interests more than any principled foundation. Moreover, just as rules-based regulation itself can tend toward encrustation, obsolescence, and difficulty in changing, safe harbors are often clearly defined rule-based exceptions and can have a similar effect. Once a safe harbor is created, it can be difficult to modify as circumstances change, in part because of the efforts of special interests to protect their preferred regulatory status. Thus, although the Taskforce recognizes the potential benefits of regulatory safe harbors as a potential response to heightened use of principles-based regulation, it also urges regulators to use initial care in drafting and enforcing their rules, rather than relying on safe harbors.

6.4.2 Enforcement

The CFPB's second primary tool is enforcement.[145] Enforcement serves two functions for a regulatory agency. First, enforcement is an important tool to deter wrongdoing and provide recompense for injured consumers for violations of law or regulations. Second, it is an important tool to support regulation, especially principles-based regulation. Under this approach, regulation primarily outlines a principles-based regulatory framework, and enforcement (along with guidance, policy statements, and other devices) can be used to flesh out the application of those principles to specific fact situations. Enforcement can also be an important tool for updating regulatory principles and applying those principles to new situations and technologies, and to protect consumers from new and emergent threats.

On the other hand, enforcement should *not* be seen as a substitute for rulemaking and "regulation by enforcement" should be avoided as a means of setting new standards for an industry or changing widespread industry practices that plausibly produce benefits for consumers. Just as regulation should be somewhat abstract and should not try to anticipate and regulate every single detail and contingency that could arise under a rule's potential application to every fact situation, enforcement should be focused on violations of established law and regulations or the clarification of regulatory principles as they apply to particular acts or practices. So-called "regulation by enforcement"—the practice of establishing *de facto* industry-wide regulatory standards without following the procedural formalities of the standard regulatory process, including the opportunity for a judge to review those standards under the Administrative Procedure Act—raises substantial rule of law and procedural fairness concerns.

[145] *See* 12 U.S.C. §5511(c)(4).

Equally important, enforcement is a poor tool to try to establish broad principles across an entire industry, as enforcement is focused on the acts of one party in one particular case. Given the narrow range of the issues raised by a particular case, regulation by enforcement lacks the rigor of the three-step process outlined above to identify and remedy market failures. Most obvious, sound regulation should be supported by rigorous cost-benefit analysis to ensure that overall consumer welfare will be improved by the regulatory action. Trying to establish broad principles though enforcement actions in a particular case or series of cases, by contrast, potentially end-runs protections to consumers provided by cost-benefit analysis and opportunities to comment on the proposed rule. As a result, when the benefits and costs of different approaches are in dispute trying to set policy through enforcement instead of rules makes it difficult to consider and measure the full range of unintended consequences that may result from the action.[146]

The perils of trying to establish efficient quasi-regulatory rules through enforcement are heightened when the agency seeks to establish broad principles through precedents established through consent agreements rather than fully-litigated cases.[147] Most of the CFPB's enforcement actions, like many other government agencies, have been resolved by consent agreements and have not been fully litigated to judgment. By their nature, consent agreements generally provide only limited and largely one-sided conclusory information regarding the factual underpinnings of a case rather than a complete public record.[148] While the limited nature of the public record is not problematic in establishing the foundations for the application of liability and remedies in a particular case, it is less reliable when serving as a precedent for future enforcement actions. In addition, although consent agreements can provide some guidance as to what the agency considers illegal behavior in a particular case, unlike an adjudication before a judge, consent agreements do not provide any precedent or information about what is *not* illegal behavior. One practice adopted by some agencies to provide guidance as to behaviors that will not incur liability is to publish "Closing Letters," announcing the termination of an investigation without any allegation of illegality.[149] The CFPB should consider adopting a similar device to provide further

[146] Consistent with this observation, the Taskforce recommends that major enforcement initiatives be subjected to retrospective review to estimate their overall effects on the market including unintended consequences, similarly to retrospective review of regulations.

[147] See Jan M. Rybnicek and Joshua D. Wright, Defining Section 5 of the FTC Act: The Failure of the Common Law Method and the Case for Formal Agency Guidelines, 21 Geo. Mason L. Rev. 1287, 1293-97 (2014).

[148] In many instances, of course, the absence of a public record is at the request of the defendant, which is not problematic for resolving the case. It is problematic, however, when extrapolating the "precedent" of a settled case to new fact situations.

[149] *See* Federal Trade Commission, "Staff Closing Letters," *available in* https://www.ftc.gov/enforcement/cases-proceedings/closing-letters-and-other-public-statements/staff-closing-letters.

guidance of types of practices that are thought to *not* be improper or investigations that are closed without action.

Moreover, unless rigorously monitored by senior management, trying to establish precedents through enforcement actions runs a risk of sending conflicting and inconsistent messages to regulated parties as to the substantive standards of liability and the damages and remedies that might assessed for violations. For example, testimony provided during the CFPB's Symposium on Abusive Acts and Practices expressed frustration with perceived uncertainty and unpredictability with respect to the CFPB's enforcement posture, both regarding the substantive definition of "abusiveness" in isolation as well as the relationship between "abusive" acts and practices on one hand and unfair and deceptive practices on the other.[150] For example, reviewing CFPB's consent agreements in actions involving allegations of unfair, deceptive, and abusive behavior, it is difficult to discern a clear pattern as to how the CFPB has defined abusive behavior, as distinct from unfair and deceptive behavior. Many consent agreements seemingly defined abusive as more or less coterminous with unfair and/or deceptive practices, yet other cases with facially-similar fact patterns resulted in only counts for abusive behavior and still other cases only include allegations of unfair and/or deceptive practices.[151]

Given this uncertainty, the CFPB's Policy Statement on Abusive Acts and Practices is a useful step toward providing greater clarity and guidance on the Bureau's understanding of what constitutes "abusive" acts and practices. That sort of guidance is useful not only to reduce uncertainty to the regulated community but also to provide internal guidance to the CFPB staff to identify enforcement priorities and to allocate the CFPB's limited investigation and enforcement resources to target those behaviors that are most harmful to consumers and to ensure greater consistency across cases.[152] Moreover, as with rulemaking, uncertainty regarding the CFPB's enforcement posture can potentially deter acts, practices, and innovations that could be beneficial to consumers because of uncertainty as to how they will be viewed by the CFPB. As noted above, the CFPB's adoption of additional mechanisms for providing additional guidance, such as Advisory Opinions, No-Action Letters, and other guidance regarding its enforcement protocols and priorities, also have been useful to increase predictability and internal coherence and consistency in policy implementation.

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[150] *See* Bureau of Consumer Financial Protection, Statement of Policy Regarding Prohibition on Abusive Acts or Practices (Jan. 24, 2020) (summarizing testimony and conclusions of CFPB).

[151] See e.g. the statements of William MacLeod and Todd Zywicki at the CFPB Symposium on Abusive Acts or Practices, available at https://www.consumerfinance.gov/about-us/events/archive-past-events/cfpb-symposium-abusive-acts-or-practices/.

[152] *See* Statement of Todd J. Zywicki, Abusive Acts and Practices, *supra* note 128.

Principles of preventing and remedying consumer harm while not discouraging beneficial conduct should guide the CFPB's approach to enforcement remedies. As with excessively broad or uncertain standards of substantive liability, excessive or unpredictable penalties for alleged violations can deter actions or the development of products and services that could provide benefits to consumers. To deter harmful behavior but not create excessive or unpredictable liability that could deter beneficial behavior, therefore, remedies should be predictable and should be grounded in consumer harm.[153] In order to gain optimal deterrence, the harm calculation should be adjusted upward to compensate for the probability that the harmful conduct will go undetected or unsuccessfully prosecuted.[154] Wherever relevant, grounding remedies in consumer harm also implies that any offsetting benefits that the consumer might have received should be considered as part of the economic damages that are recovered.[155] In reading many CFPB enforcement cases, it is not always evident how the CFPB arrived at the damages it seeks in particular cases or the degree to which the damages sought are grounded in consumer harm.

Without knowing predictably the scope of damages that the CFPB is likely to pursue in the event of consumer harm, CFPB attorneys and regulated parties will have difficulty discerning what harms the CFPB considers to be, on net, most harmful to consumers and to which limited enforcement resources should be allocated. Therefore, in order to more rationally prioritize internal enforcement resources and to be careful not to deter socially beneficial economic activity, the CFPB should consider providing more clarity and guidance to regulated parties. The other financial regulators, for example, identify the relevant factors they will consider in setting remedies through a public matrix or some similar device. Although those matrices are not binding on the agency, they do provide information to regulated parties as to the greatest concerns of their regulators and the risk of liability exposure when establishing internal processes and procedures and allocating scarce internal resources toward regulatory compliance.

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[153] *See* James C. Cooper and Bruce H. Kobayashi, *Equitable Monetary Relief Under the FTC Act: An Opportunity for a Marginal Improvement*, George Mason University Law & Economics Research Paper Series, 20-06 (March 2020), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3549899.

[154] *Id. See also* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968); A. M. Polinsky and Steve Shavell, *Punitive Damages: An Economic Analysis*, 111 Harv. L. Rev. 869 (1998).

[155] *See* Cooper and Kobayashi, *supra* note 153.

6.4.3 Supervision

A third tool possessed by the CFPB to carry out its mission is supervision.[156] Although government inspections are a common tool of consumer protection enforcement, the CFPB's authority to engage in ongoing supervision to the extent it does is unusual. Moreover, although supervision is quite familiar to depository institutions, it is somewhat novel for non-bank entities. The presence of a supervisory power for consumer protection purposes further reflects the unusual nature of the CFPB as a hybrid of a consumer protection and financial regulatory agency in using a conventional tool of prudential regulation to further the CFPB's mission of consumer protection.

The Dodd-Frank Act's rationale for providing CFPB with supervisory authority is unclear, and the precise objectives that supervision is designed to accomplish is also unclear. According to the Dodd-Frank Act, the purposes of supervision are to "assess[ ] compliance" with the law, obtain information about the activities and compliance systems of the entity, and to "detect[ ] and assess[ ] risks to consumers and to markets for consumer financial products and services."[157] According to the Dodd-Frank Act, the primary purpose of nonbank supervision is "based on the assessment by the Bureau of the risks posed to consumers in the relevant product markets and geographic markets."[158] The Dodd-Frank Act lists several considerations that the CFPB should take into consideration in making this assessment. Notably, however, the Dodd-Frank Act does not specifically instruct CFPB to make an explicit cost-benefit consideration in determining which institutions to supervise and how to conduct supervisory policy.

The Bureau's supervisory authority is unrelated to the rationale for the traditional supervisory authority over banks by prudential regulators. Exercise of supervision by regulatory authorities over banks evolved into its current form in response to the implementation of the system of deposit insurance that began as part of the New Deal.[159] The availability of deposit insurance to

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[156] *See* 12 U.S.C. §5511(c)(4); 12 U.S.C. §5514 (providing supervisory authority over nondepository institutions); 12 U.S.C. §5515 (supervisory authority over banks, thrifts, and credit unions with more than $10 billion in assets).

[157] *See* 12 U.S.C. §5514(b).

[158] *See* 12 U.S.C. §5514(b)(2).

[159] *See* Eugene N. White, *Lessons from the History of Bank Examination and Supervision in the United States, 1863-2008, in* Financial Market Regulation in the Wake of Financial Crises: The Historical Experience 15, 16 (Alfredo Gigliobianco and Gianni Toniolo eds., 2009). White notes that although examination of banks have existed since the earliest days of the banking system, until the 1970s the primary purpose of examination for much of that time was to reduce the moral hazard problem by reinforcing market discipline and later as a mechanism for effectuating Federal Reserve monetary policy by controlling reserves and lending activity. The modern supervisory structure focused on bank safety-and-soundness arose in the 1970s in response to financial liberalization that exacerbated the moral hazard problem that had previously been controlled through strict regulation of bank's activities. *See also* Donato

protect small creditors of the bank (depositors) gives rise to a moral hazard problem, that the bank will have an incentive to hold insufficient reserves and take excessive risk. Supervision attempts to mitigate this moral hazard problem by monitoring the bank's ongoing performance and risk-taking activities to ensure that the bank is not engaging in overly risky activity. Because lending risks are often difficult to observe externally, supervision provides a mechanism to prevent such behavior from occurring.

The rationale for providing supervision as a tool for consumer protection is unclear, however, especially with respect to nonbank providers. Unlike the unobservable moral hazard problem that justified supervision by prudential regulators, consumer protection deals with observable harms to third parties, although not always in ways easy or costless to detect. It is thus not clear what precisely what the architects of the Dodd-Frank Act were seeking to accomplish through granting extensive supervisory authority to the CFPB, including detailed oversight of their compliance procedures, as opposed to providing the CFPB with enforcement and rulemaking authority while allowing supervision to remain an element of the supervision power of prudential regulators. The "level playing field" idea that banks and nonbanks offering similar products should be subject to comparable levels of oversight may be part of the explanation in sone cases, but it is simply not applicable to supervision of other entities, such as credit reporting agencies or debt collectors, that have never been in competition with banks. Nor is it obvious from the Dodd-Frank Act how its supervisory power should fit with the CFPB's other more traditional consumer protection powers of regulation and enforcement.

Given this traditional justification for supervision, the purpose of granting supervisory power is even more puzzling with respect to non-bank lenders, such as small-dollar lenders that offer simple, largely homogeneous products to the public and for which harm is relatively easy to detect through consumer complaints. At the same time, the supervisory process can impose substantial costs and disruption on regulated parties in terms of preparing for and carrying out supervision visits. The supervision office of the CFPB also consumes a large number of resources, as it is the single largest office within the CFPB, employing almost 500 employees in total, with the vast majority of them situated in regional offices around the country, or about one-third of the entire CFPB staff headcount.[160] In light of the significant resource costs for both the CFPB

Masciandaro and Maarc Quintyn, *The Evolution of Financial Supervision: The Continuing Search for the Holy Grail* 263, 267, *in* 50 Years of Money and Finance: Lessons and Challenges (Morten Balling and Ernest Gnan eds., 2013).

[160] The Enforcement division is the second-largest division within the Bureau, with about 150 employees. The divisions of Regulations, Research, Financial Education, and Markets all have fewer than 100 employees each. *See* Consumer Financial Protection Bureau Internal FY 2020-2021 Approved Staffing documents (Oct. 2020) (reviewed by Taskforce). In total, the Division of Supervision, Enforcement, and Fair Lending has 630 employees, which comprises approximately 43% of the CFPB's total employee headcount of 1459.

and the regulated community of the supervisory process, the Taskforce encourages the CFPB to articulate more rigorously its overall objectives in using its supervision authority and thereby to estimate the relative costs and benefits of supervision as well as the different supervisory approaches and enforcement.

This absence of a clear purpose for the CFPB's supervisory power is reflected in the CFPB's rulemakings regarding "larger participants." The Dodd-Frank Act does not establish clear criteria for the CFPB to use in to determine what constitutes a "larger market participant" across markets. In some instances the CFPB has interpreted its charge to focus on a firm's financial receipts and in other situations the criteria is primarily the number of accounts they service.[161] Even where the same criteria are used to identify a larger participant, such as revenues, the amount varies from one market to another but it is not clear what criteria are used to draw the line.[162] The touchstone for the inquiry for drawing the threshold lines seems to be focused on ensuring that the CFPB supervises a sufficiently large number of firms to cover a large percentage of the market.

We do not suggest that the standards for "larger participants" should be identical across all markets, which obviously differ. Subjecting firms to supervision, however, involves a commitment of resources by the Bureau, resources that could be used elsewhere. The Bureau should think systematically about the allocation of its supervisory resources, and that thinking should be reflected in the underlying principles that guide "larger participant" rules. Yet the inquiry does not appear to rigorously assess the marginal benefits in terms to consumers in light of the marginal costs of exercising supervision, whether to regulated firms or in terms of internal resource allocation for supervision as opposed to other Bureau operations or supervision in other markets.

Another potential cost of the larger-market participant rule is the potential for "threshold effects" around the level established by the regulation. To the extent that being subject to supervision is

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[161] *Compare* Defining Larger Participants of the Consumer Debt Collection Market, 77 Fed. Reg. 65775, 12 CFR 1090 (Oct. 31, 2012) ("larger participants" are those with over $10 million in receipts, excluding medical debts) *with* Defining Larger Participants of the Student Loan Servicing Market, 78 Fed. Reg. 73383, 12 CF 1090 (Dec. 6, 2013) ("larger participants" are those with more than 1 million active accounts), *with* Defining Larger Participants of the Automobile Financing Market and Defining Certain Automobile leasing Activity as a Financial Product or Service, 80 Fed. Reg. 37496, 12 CFR Parts 1001 and 1090 (June 30, 2015) (defining "larger participants" in nonbank auto finance market as those with at least 10,000 aggregate annual originations of auto loans or leases).

[162] *Compare* Defining Larger Participants of the Consumer Debt Collection Market, *supra* note ($10 million in receipts) *with* Defining Larger Participants of the Consumer Reporting Market, 77 Fed. Reg. 42873, 12 CFR 1090 (Sept. 30, 2012) (defining "larger participant" as those with "more than $7 million in annual receipts from relevant consumer reporting activities").

effective in achieving compliance, crossing over the line that identifies a larger-market participant will increase the cost and risk associated with regulatory compliance as well as requiring investments in new expertise and compliance management.

Threshold effects have not been studied in the context of entities subject to “larger participant” rules, but they have been observed in banks. “Banks face a discontinuous increase in regulatory burdens as they cross these fixed nominal asset thresholds. As such, they may act to curtail their normal growth if that growth would put them just above a threshold.”[163] Anecdotal reports and some empirical data suggest that some financial providers in some instances might artificially limit their growth to avoid triggering this threshold; alternatively, in order to deal with the discrete jump in costs associated with going over the threshold can create incentives for banks to merge with a larger bank rather than continuing to grow organically in order to capture greater economies of scale in regulatory compliance costs.[164] Although these costs are inherent in setting any regulatory threshold that results in a discrete increase in costs, in setting the threshold level, the CFPB should be conscious not to set the limit too low so that it artificially deters organic growth or encourages otherwise-inefficient mergers and should be diligent about updating those thresholds as needed, such as by adjusting any dollar value thresholds automatically according to inflation.[165]

6.4.4 Education and Financial Literacy

Consumer education and financial literacy can be a powerful tool for empowering consumers to improve their financial well-being and more efficiently shop for the products and providers that best meet their subjective needs. More informed consumers might also be expected to be less susceptible to being duped by fraudulent and deceptive practices.

Consumer financial education, like other types of general education, has a public goods effects that make this an appropriate tool for a government agency, such as the CFPB, to provide. General domain consumer financial education has a complementary interaction effect with the

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[163] David Hou and Missaka Warusawitharana, *Effects of Fixed Nominal Thresholds for Enhanced Supervision*, FEDS Notes (July 19, 2018), *available in* https://www.federalreserve.gov/econres/notes/feds-notes/effects-of-fixed-nominal-thresholds-for-enhanced-supervision-20180719.htm.

[164] *See* Shradha Bindal, Christa H.S. Bouwman, Shuting (Sophia) Hu, and Shane A. Johnson, *Bank Regulatory Size Thresholds, Merger and Acquisition Behavior, and Small Business Lending*, 62 J. Corp. Fin. 1 (2020); Hailey Ballew, Michael Iselin, and Allison Nicoletti, *Accounting-Based Thresholds and Growth Decisions in the Banking Industry*, __ Rev. Accounting Studs. __ (forthcoming 2020); Hou and Warusawitharana, *supra* note 163.

[165] *See* Hou and Warusawitharana, *supra* note 163.

provision of product-specific information and disclosures about products and providers. Consumer education and financial literacy aims at developing consumers' general competency in financial planning and decision making and enabling them to better protect themselves from harm. As discussed in Chapter 7, effective disclosure and provision of information about the terms and conditions of certain products helps consumers to make better decisions about particular products and services and to reward high-quality providers of financial services at the expense of low-quality providers. As a result, there is a complementary interaction between consumer education and literacy, as building increased capability in consumer financial decision-making and planning through financial education will increase the effectiveness of information provided about specific products and providers. Consumers with higher levels of general ability in consumer education and literacy should be able to shop more effectively and to make more effective use of information provided by mandated disclosures as well as advertising and other sources of information. No individual financial institution can capture all of the benefits associated with a more educated and financially literate consumers, there is a potential for underinvestment in those general problem-solving skills. As a result, effective financial education can be a legitimate function for government and the non-profit sector and can be a valuable tool to advance the CFPB's missions of consumer protection, competition, and inclusion.

Moreover, informed and educated consumers also provide external benefits to *other* less-informed consumers by making informed choices on markets by rewarding high-quality providers and driving low-quality providers out of the market. As a result, if sellers are unable to easily distinguish between informed and uninformed consumers, then sellers will tend to compete at the margin for those consumers who shop more aggressively. This will tend to lead to the growth of higher-quality providers and higher-quality contract terms in competitive markets. More highly informed consumers can provide external benefits for consumers who are less informed and less sophisticated. To the extent that consumer preferences differ, competing bundles of terms will also emerge; that is the essence of product differentiation. Moreover, consumers who lack understanding of financial concepts can harm not only themselves but also might create negative externalities for other consumers and the economy. Financial distress has impact not only on the borrower but also other individuals as well. When a borrower is unable or unwilling to repay borrowed funds, those losses eventually must be passed on to other consumers. Taxpayers as a whole subsidize the bankruptcy system. As seen during the height of the late-2000s mortgage crisis, homes that fall into foreclosure can exert a negative impact on the value of neighboring properties.[166] Individuals who fail to save adequately for retirement will

[166] Such externalities, however, seem to have been substantially overstated during the financial crisis. Research found that these "externalities" arose from reduced investments by distressed homeowners in the foreclosed property and tended to be short lived. Adoption of policies that slowed the resolution of the property from default to foreclosure

draw more heavily on public welfare programs than those who do save. Consumers with higher levels of financial education might be expected to be less likely to make decisions that lead to financial distress which will benefit both themselves and others.

Thus, consumer education, like investments in education generally, has elements of a public good that potentially provide a rationale for government action to promote financial literacy. The more equipped that consumers are to make good financial decisions and avoid bad decisions, the larger the overall benefits for society and the economy. A detailed evaluation of the effectiveness of current consumer education programs and curriculum, as well as suggestions for improvement, is provided in Chapter 12. For current purposes, it is relevant to identify the potential role for consumer education as a tool for consumer financial protection in supplementing the three legs of the consumer protection stool. Educated and empowered consumers are the foundation of making competitive markets work better to help push markets toward higher-quality, lower-prices, greater innovation, and more fair practices and contract terms. Better educated consumers are also less likely to be harmed by fraudulent and abusive practices, thereby reducing the need for subsequent private litigation and government action.

It should be stressed, however, that although consumer education can be valuable in its own right and a useful complement to other regulatory tools, it is not a panacea for consumer harm nor is it a substitute for a robust public consumer protection enforcement and regulatory regime. The value of financial literacy as a regulatory should be assessed with a realistic appraisal of both its potential value and its limits. Consumers face constraints on their time and attention, which limits their patience for developing consumer literacy tools. As discussed in Chapter 12, like other types of education, financial knowledge tends to depreciate without recurrent use and reinforcement. More important, many consumer financial products are inherently complex and difficult to understand. Most of this complexity is inevitable in the provision of financial products—credit cards, for example, are used for many different functions, including transactions, borrowing, online shopping, security, and many others. Given the varied uses of credit cards, there is a certain irreducible minimum level of complexity. Mortgages are also highly complex, partly because of the inherent complexity and risks of the product but also because of a complex web of regulatory-induced complexity. As discussed in Chapter 7, consumers are bombarded with information and disclosures regarding the goods and services that they consume. All of this means that even the most-informed and diligent consumer is unlikely to be able to read and understand all of the details of all of the financial products (and

increased the negative effect of mortgage distress on house prices. Still, default and eventual foreclosure cast a temporary shadow that depressed surrounding home prices. *See* Kristopher Gerardi, Eric Rosenblatt, Paul S. Willen, and Vincent Yao, *Foreclosure Externalities: Some New Evidence*, 87 J. Urban Econ. 42 (2015).

other products) that they encounter and will be unable to protect themselves from all fraudulent activity. Thus, while financial literacy provides a first line of defense against illegal practices and a catalyst for competitive markets, it should be seen as having a role first in making markets work more effectively for consumers and also for complementing other tools and making them more effective.

6.4.5 Policy Research and Development

A fifth tool for a financial consumer protection regulator is policy research and development. As noted above, the predicate step toward deciding whether government intervention and regulation is appropriate is to first accurately identify the market failure and the range of possible responses to address it. Finally, the proposed solution should be evaluated to determine whether the benefits of the proposed intervention exceed the costs.

In many instances, however, it is unclear the extent to consumers have actually been harmed and, if so, what the source of that harm is. Moreover, even if the nature of the harm can be identified, in many cases it is not obvious what the appropriate policy response to the proffered harm might be. Sound economic research can be useful to frame these issues and to develop effective and efficient responses to market failures. Research and analysis can also be useful to retrospectively analyze the impact of prior agency actions, or inactions, to determine whether certain policies should be amended, expanded, or curtailed. Although often overlooked in the bright glare of enforcement and rulemaking, an agency's research function supports all of the agency's tools by helping to develop the agency's agenda and priorities and helping to direct the agency's resources to those ends that will best serve consumers.

The research function of agencies has been referred to as "policy research and development" because of its foundational role in providing direction and mission to an agency, to help it identify the greatest opportunities and threats to consumer financial welfare.[167] As former FTC Chairman William Kovacic has noted, the label takes its inspiration from the observation that "These are public sector capital investments that resemble the R&D outlays that a company makes to improve the range or quality of its 'products.'"[168] Kovacic notes that one of the values promoted by policy R&D investments is the creation of "economic precedents," i.e., studies that

[167] See William E. Kovacic, Measuring What Matters: The Federal Trade Commission and Investments in Competition Policy Research and Development, 72 Antitrust L.J. 861 (2005); see also Timothy J. Muris, Looking Forward: The Federal Trade Commission and the Future Development of U.S. Competition Policy, 2003 Colum. Bus. L. Rev. 359 (2003).

[168] Kovacic, *supra* note 167, at 862.

can evaluate the validity of a hypothesis that can be later relied upon in assessing the wisdom of a proposed policy intervention.[169] Rigorous performance measurement and evaluation of previous interventions can also provide feedback for improved policymaking. As the Federal Trade Commission noted a decade ago, "An agency that intends to be thoughtful and to consider its policy actions seriously must have some ability to analyze the trade-offs inherent in any policy choice."[170] Policy R&D takes on a heightened importance at the CFPB in light of the reality that policy-oriented research related to consumer finance has not been in vogue among academic economists in recent decades.

To be useful, however, it is important that any analysis be independent from the agency's staff that has contributed to or is otherwise invested in the substantive policy. In this vein, the Taskforce commends the CFPB's Office of Research for its recent announcement of a new procedure for external peer review of important Bureau research.[171] The CFPB should consider extending cost-benefit analysis to its enforcement actions as well even if such analysis would be less precise than for rules. Nevertheless, because enforcement actions typically do not have any rigorous analysis of tradeoffs as part of the process—unlike rulemaking, in which policy R&D and cost-benefit analysis are embedded in the decision-making process itself—it is essential for the CFPB to be proactive in conducting research to ensure that its actions are on net beneficial to consumers.

Of particular importance in strengthening the CFPB's policy R&D functionality is its important series of Symposia on various topics that it convened beginning in 2019. These programs bring together leaders from academia, think tanks, consumer advocacy groups, industry members, and former governmental officials to provide a wide-ranging analysis of areas of importance to the CFPB and its mission and to help develop policy. The CFPB's Symposium on Abusive Acts and Practices, for example, provided the foundation for its later Abusiveness Policy Statement. Symposia and workshops that rely heavily on an array of outside participants can be particularly important in emerging areas as the agency seeks to build capacity and to respond to emerging threats to consumers and opportunities to promote competition and innovation.

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[169] *Id.* at 865.

[170] Federal Trade Commission, The Federal Trade Commission at 100: Into our 2nd Century, The Continuing Pursuit of Better Practices at p. xiii (Jan. 2009).

[171] *See* Jason Brown, Consumer Financial Protection Bureau, *Bureau Adopts New Procedures for External Peer Review of Important Research*, CFPB.gov (Aug. 28, 2020), *available in* https://www.consumerfinance.gov/about-us/blog/bureau-adopts-new-procedures-external-peer-review-research/.

As an adjunct to its research function, the Taskforce believes that the CFPB should consider adding an "Advocacy" function to its consumer protection toolkit. Under this approach, the CFPB can bring its expertise to bear to advise other agencies, state and federal policy-makers, and judges about the likely consequences of their actions for consumer welfare, including the effects on competition and inclusion.[172] Few other government offices have the potential depth and breadth of knowledge about consumer financial protection and innovation the CFPB has with respect to the matters under its scope. Advocacy can be particularly important with other financial regulators, which tend to have narrower constituencies than does the Bureau. The CFPB's can be particularly helpful in this area where other governmental actors are considering taking actions that would be harmful to innovation or competition that would raise prices and reduce choices for consumer. Many proposals clothed in the garb of "consumer protection" are instead promoted by interest-groups to protect themselves from competition. The CFPB's expertise and independence provides with the authority to explain why facially attractive ideas such as usury controls could have adverse unintended consequences for consumers.

6.4.6 Internal Reorganization and Effective Use of Regulatory Tools

As should be clear from this discussion, regulatory tools are a means to the end of maximizing consumer welfare broadly described to include consumer protection, inclusion, competition, and innovation. Since its inception, the divisions of the CFPB have been organized primarily around its several regulatory tools, in addition to its enumerated statutorily-mandated offices and other functions.[173] With respect to its tool usage, the CFPB has a division of Supervision, Enforcement, and Fair Lending (containing within in it Offices of Enforcement, Supervision Policy, and Supervision Examinations). and a division of Research, Markets & Regulation, with Offices of Research, Regulations, and three markets-related Offices (Consumer Credit, Payments, and Deposit Markets; Mortgage Markets; and Small Business Lending Markets). Thus, for example, all regulations are drafted in the Office of Regulation, regardless of the subject matter. And although the Office of Regulation is within the same division as the Offices of Research and

[172] *See* Federal Trade Commission, *supra* note 169, at xvi; *see also* James C. Cooper, Paul A. Pautler, and Todd J. Zywicki, *Theory and Practice of Competition Advocacy at the FTC*, 72 Antitrust L.J. 1091 (2005).

[173] The Bureau has four statutorily mandated offices, including the Office of Financial Education, the Office of Fair Lending and Equal Opportunity, the Office of Service Member Affairs and the Office of Financial Protection for Older Americans. The Bureau also has several ancillary and support functions, including external affairs, legal affairs, and consumer response. These offices are essential to carry out the Bureau's statutory mission but do not raise analytical questions with respect to their organization for the Taskforce to consider.

relevant markets, it bears no formal structural overlap with, for example, the Offices of Supervision or Enforcement.

To better align the CFPB's regulatory tools to improve consumer welfare at lowest cost, it is the view of the Taskforce is that the CFPB should consider reorganizing its internal operations so as to reorganize around the various markets it oversees (e.g., small-dollar lending, mortgages, credit cards, collections and servicing, etc.), rather than organizing around its regulatory tools or functions. In the view of the Taskforce, this step could help the CFPB to develop deeper expertise with respect to the markets, products, providers, and consumers it oversees, and to use its various tools in coordination with one another to advance consumer welfare. If the CFPB rejects this proposal, it is the view of the Taskforce that the CFPB should consider taking steps to more formally address some of the problems identified below that arise from its current structure.

The tool-based organizational structure of the CFPB can lead to some potential difficulties in decision-making. Most important, by organizing around tools instead of markets, the current structure of the CFPB makes it difficult to ensure that the optimal combination of tools is being used to protect consumers and promote competition and inclusion at the lowest cost. This can result in some degree of tunnel vision that has prompted some of the more frequent criticism of the Bureau's operation. Most notable, the CFPB was criticized for its perceived practice of "regulation by enforcement," i.e., using individual cases, particularly negotiated consent agreements, to try to impose industry-wide practices on market participants while circumventing the protections provided by the notice and comment rulemaking procedure and subsequent judicial review under the Administrative Procedure Act. Even when the potential concerns of other divisions are taken into account, outside of the context of an understanding of the market, they may result in inferior policy choices. Principles-based rules, for example, are likely more challenging for examiners to apply and may introduce litigation uncertainties, but as discussed above, such approaches are generally preferable to detailed prescriptive requirements. A staff with expertise in the market is better positioned to assess the tradeoffs. Thus, in some instances, CFPB rules have been extremely detailed and prescriptive. For example, in the 2017 Small-Dollar Loan Rule, the Bureau not only required the industry to evaluate a consumer's ability to repay the loan, it dictated a particular formula for doing so, thereby preempting potentially superior or proprietary systems. It is possible that internally organizing the CFPB around markets and products, instead of tools, could avoid the tendency for each division to tend to overvalue its own particular tool as providing a comprehensive response to every consumer protection problem.

Moreover, under the current structure it is difficult for any employee or division to develop deep, ongoing familiarity with the developments in any particular market. By combining enforcement and rulemaking (including more informal acts such as guidance or policy statements) within a particular division, it becomes more efficient to determine how certain rules are operating in practice and where they might need clarified. It would also make it easier to use tools in a complementary fashion, such as to use principles-based rulemaking (in which the particular division is highly familiar with the principles that animated the rule) to be fleshed out through supervision, enforcement, and other issues. In addition, by linking research functions more closely to particular markets and consumers, the Bureau could be better able to anticipate emerging questions in various markets and to do conduct timely policy-relevant research and to prioritize research projects within the division. In short, by organizing around markets instead of tools, the various divisions could develop deeper subject-matter expertise as well as to adjust their mix of tool usage as time goes on.

Organizing the Bureau's operations around markets would have the additional benefit of strengthening its ability to implement a consumer-centered process of analyzing markets and the competitive process. For example, in the eyes of consumers, payday loans are seen to compete on one hand with bank overdraft protection and on the other hand with pawnbrokers.[174] Historically, those various products have been regulated by different regulatory authorities using different approaches (enforcement versus supervision). Yet the optimal regulatory policy with respect to payday loans is tightly intertwined with the accessibility of overdraft protection as those two products compete for customers at the margin. Although navigating the division lines among products can be complicated, situating payday loans, overdraft protection, and pawn shops within a division of "small-dollar products" could deepen the Bureau's understanding about how those various products interact.

The difficulties that can arise from the current CFPB structure is highlighted by the peculiar division of authority with respect to the Bureau's larger market participant rules. As discussed, one difficulty with the Bureau's definition of large market participants is that it is difficult to determine in the abstract what constitutes a larger market participant and where to draw the threshold line to distinguish those institutions that should be subject to ongoing supervision from those that should not. Moreover, once that line is drawn, there remains the question as to whether it has been drawn according to the correct criteria (to maximize consumer protection and lowest cost to providers and consumers) or in the correct place. Presumably, those rules should be subject to ongoing consideration and perhaps regular formal updating as the Bureau develops new information about the wisdom of the current practice and whether new product markets and providers should be supervised. This information as to whether the criteria or threshold should be adjusted would be most likely to emerge from ongoing communications with the regulated industry, enforcement actions, and research as to emerging threats and developments in the market. This suggests a feedback loop between the costs and benefits of

[174] Clarke and Zywicki, *supra* note 32.

supervision under its current configuration, its complementary operation with enforcement, research as to its relative costs and benefits compared to other tools, and feedback into whether the rule itself should be revised or whether new rules should be issued for new products.

Under the current organizational structure of the Bureau, this process is more cumbersome. The rulemaking division issues rules relative to larger participant criteria and thresholds. Supervision actually allocates its resources to determine how to implement those rules and how to cooperate with enforcement. But the feedback loop from the research division with new information and to the rulemaking division as to whether the rule is working effectively can be less than efficient.

The Taskforce recognizes that reorganizing the Bureau around markets instead of tools would raise new challenges. The division between markets will not always be clear. Organizing operations around markets also will not entirely eliminate the challenges of cross-Bureau coordination: it will simply raise new challenges of coordination across markets instead of coordination across tools. Still, the Taskforce believes that the potential benefits of reorganizing around markets in terms of deepening expertise and increasing the effectiveness of tool usage outweighs these potential coordination costs. For example, although it is possible that over time some inconsistencies could arise in the interpretation of, say, the "unfairness" standard as applied to debt collectors versus credit card issuers, it is the view of the Taskforce that consistent application to all of the competitors in a given market is particularly important—whether articulated as part of rulemaking, supervision, or enforcement. Assuring consistent application of the underlying legal standards across markets is an easier task for the General Counsel and the Director's Office than is assuring consistent advice and direction to competing firms.

Finally, as a further element of this effort to make its use of regulatory tools more effective, the Taskforce also recommends the creation of an Office of Policy Planning (OPP) within the Bureau to coordinate cross-bureau operations and assessment. OPP could perform a variety of functions. The existing Office of Strategy could be relocated into this OPP as part of the Bureau's comprehensive strategic planning and assessment operations. OPP could also serve as an institutional location to coordinate for important bureau objectives that cut across its various tools and markets, such as the initiatives and programs of the Office of Innovation and promotion of the Bureau's statutorily-mandated mission to promote competition in consumer finance markets. OPP could be the location of an independent internal cost-benefit analysis functionality operating in collaboration with similar offices within the divisions. OPP could serve as the location for a new competition and consumer protection advocacy function for the Bureau to provide advice to state and federal regulators regarding policies to effectively protect consumers and promote competition, innovation, and access in consumer financial markets. OPP could be tasked with special projects, such as retrospective review of major enforcement efforts to determine their efficacy and efficiency. Finally, and most relevant for the current discussion, OPP could be responsible for promoting internal coherence and consistency of policies and priorities throughout the Bureau's various actions and activities.

7. Information and disclosure

A central pillar of the National Commission on Consumer Finance's (NCCF) focus was empowering consumers through the provision of information in a standardized, user-friendly format. This interest of the NCCF in the topic of information provision was not merely a coincidence—the NCCF itself was created by the Consumer Credit Act of 1968, the same legislation that enacted the Truth in Lending Act (TILA). According to the NCCF, providing consumers with the opportunity to have "full knowledge of [their] credit transactions" was central to the process of enabling consumers to protect themselves against overreach by providers and to "assure that competition is meaningful."[1]

The federal role in financial consumer protection began with an information problem. Subject to state regulation under different statutes and regulatory structures for different institutions, lenders stated the interest rate on their products in a variety of manners that greatly complicated comparisons, particularly across different institutions from which a consumer might seek credit. As noted by the NCCF, prior to the enactment of TILA, state laws varied widely in their disclosure requirements, frustrating the efforts of consumers to meaningfully shop among different providers. In particular, "the greatest lack of uniformity was in the quotation of the amount and rate of the finance charge."[2] Under the Uniform Small Loan Law advocated by the Sage Foundation, lenders disclosed an effective interest rate that included all credit costs and applied to the declining loan balance. Morris Plan or industrial banks expressed rates as a discount rate plus fees. For a $100 loan at 6 percent discount plus $2 in fees repaid over the course of a year, the cost as a percentage of the average loan balance would be over 17 percent. Retailers used an "add on" rate, where credit charges were added onto the cash price of the merchandise. A $100 purchase at a 6 percent add-on rate would cost $106 over 12 months.[3] As a result, it was "almost impossible" for consumers to compare offers across industries.[4] As

[1] National Commission on Consumer Finance, Consumer Credit in the United States 4 (1972).

[2] NCCF Report, *supra* note 1, 169.

[3] *See* Anne Fleming, *The Long History of "Truth in Lending"*, 30 J. Pol'y Hist. 236-271 (2018).

[4] NCCF Report (1972), *supra* note 1, 170.

the NCCF noted, "As a result of these varying forms of quoting the rate of charge, consumers could often compare rates among lenders in one class, such as commercial banks, but seldom between classes of lenders, such as credit unions and commercial banks."[5] This lack of consistency in state laws "helped create a climate favorable for legislation requiring uniform quoting of rates of charge."[6]

Prior to TILA, consumers reflected a low degree of understanding and awareness of the actual cost of credit, especially in comparing offers of different amounts and maturities.[7] As part of its proceedings, the NCCF authorized two studies to determine the initial effectiveness of TILA.[8] In the period immediately following the enactment of TILA and the publication of the NCCF's Report, the Commission concluded that the enactment of TILA had increased awareness by consumers of the APR on loans.[9] Increased awareness among consumers was not uniform, however, as consumers with lower education levels and income, minorities, and renters exhibited lower awareness levels of APR. Moreover, the persistence of retailers as leading credit providers, and their tendency to reprice credit terms into the price of goods purchased, undermined the usefulness of APR disclosure in sales credit.[10] Because the use of sales credit was much greater in higher-risk markets than in the general market, this lack of transparency in sales credit exacerbated the already-existing challenges for these groups to grasp the full price of credit transactions.[11]

Truth in Lending addressed this lack of comparability with a standardized "all in" cost measure, the annual percentage rate. The APR has become a widely recognized shopping tool for consumers, and along with other developments has helped enhance competition in consumer credit markets. As discussed in more detail in Chapter 8, this increased competition has greatly benefited consumers. The standardized disclosure of an effective interest rate including all

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[5] NCCF Report (1972), *supra* note 1, 170.

[6] NCCF Report (1972), *supra* note 1, 170

[7] *See* NCCF Report (1972), *supra* note 1, 170.; *see also* F. Thomas Juster and Robert P. Shay, Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation (1964).

[8] Robert P. Shay and Milton W. Schober, Consumer Awareness of Annual Percentage Rates of Charge in Consumer Instalment Credit: Before and After Truth in Lending Became Effective (1972); George S. Day and William K. Brandt, A Study of Consumer Credit Disclosures: Implications for Present and Prospective Legislation (1972).

[9] *See* NCCF Report (1972), *supra* note 1, at 175-179.

[10] *See* NCCF Report (1972), *supra* note 1, at 180-182.

[11] As discussed in chapter 10, the higher rate of usage of sales credit by higher-risk households during this period resulted as a by-product of usury ceilings, which led retailers to increase the price of the goods they sold to offset their inability to charge a market rate for credit.

credit costs in Truth in Lending has thus been an important success story in federal consumer financial protection. As Durkin and Elliehausen note, "TILA and the other information-based protections undoubtedly have encouraged these trends [toward greater competitiveness] in consumer-oriented credit markets, at a minimum by standardizing much lending terminology and making it more familiar to diverse consumers."[12]

Conceptually, disclosure is a more attractive approach to consumer protection than is substantive regulation of financial products and services because it respects consumer preferences and allows for the different circumstances of different consumers. Substantive regulation must either limit all consumers to essentially the same product, or establish criteria for determining who is eligible for which product. Even product features that may seem highly suspect in most circumstances, such as no- or low-documentation loans, have their place in serving consumer needs, as numerous consumers who are self-employed or gig workers have discovered. Such income is very difficult to document in a way that is both reliable and predictive of future income.

The apparent success of Truth in Lending spawned a wave of ever more comprehensive, and complex, disclosures. Truth in Lending itself has grown far beyond the original proposal to disclose two items, the APR and the finance charge. Other statutes requiring extensive disclosures have also proliferated, including the Consumer Leasing Act, the Real Estate Settlement Procedures Act, the Truth in Savings Act, and the Electronic Fund Transfer Act to name a few.[13]

These disclosure requirements are all part of an effort to make sure consumers do not make financial product decisions based on "incomplete" information. "Complete," of course, is never defined, which is part of the reason disclosures have expanded. There is always something more that can be disclosed, and when it is brought to the attention of policymakers, it has been added to the required disclosures. In many respects, as we discuss in detail in this chapter, this pursuit of complete information is an endless pursuit of a mirage. There is no oasis at the end of the journey.

We all make dozens, if not hundreds, of decisions every day without consciously thinking or benefiting from complete information. It is not because we fail to recognize that additional

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[12] THOMAS A DURKIN AND GREGORY ELLIEHAUSEN, TRUTH IN LENDING: THEORY, HISTORY, AND A WAY FORWARD, Table A.1, p. 178 (2011).

[13] DURKIN AND ELLIEHAUSEN (2011), *supra* note 12. A comprehensive listing – 14 pages long -- of required financial market disclosures for consumer is in Appendix Table A.1.

information or deliberation might improve our choices. Rather, it is because finding and using information is costly—it consumes some combination of time, money, and, perhaps most important, attention. Making decisions, even complex and potentially consequential financial decisions, with incomplete information is the rational, and optimal, choice for any consumer. Even simplified decision rules, such as focusing on the one element of a transaction that is most important to an individual consumer, can be the most rational choice. Nevertheless, the common regulatory response to the observation that consumers are not using certain information that someone believes should be used is to require disclosure of that information. Disclosure requirements have grown substantially over time, resulting in a complex web of detailed disclosures that is a compliance labyrinth for regulated entities and of questionable value as a means of protecting consumers or better informing consumers' decisions.

There is nothing particularly unique about consumer financial decisions. All consumer decisions depend on information, and that information is gathered and utilized in the same fashion for any consumer product. Some financial decisions are complex, but so are many other consumer purchasing decisions. We recognize that consumers of automobiles or computers make perfectly adequate decisions concerning how much information to obtain about the best product to buy, and which features are worth the cost. Deciding where to live and what kind of house to buy is certainly a complex decision, but we rely on consumers to do an appropriate amount of shopping and make reasonable choices. Then the flurry of required disclosures for financing the transaction becomes a blizzard of paper.

This chapter explores the related issues of the costs of information, markets for information, including seller-provided information, and how consumers use and process information. The chapter also discusses disclosure and the difficulties of effective communication.

7.1 The Economics of Information

One of the simplifying assumptions in the textbook model of perfect competition is that all participants have complete information. Although this simplification yields important insights, it obviously does not describe reality. Instead, many economic decisions are made with incomplete information. If consumers lack information about product benefits, they may undervalue the product and not consume as much as they would with more complete information. A more common regulatory concern is that consumers may lack information about drawbacks of a product, in which case they may overvalue it and consume more of it than they would otherwise. If consumers lack information about competing offerings, sellers have at least some market power because they will not lose all their business as a result of a higher price or lower quality.

In fact, among the many decisions that market participants must make are choices about how much information to acquire. Although concerns about imperfect information have a long history, the economics of information was formalized in an influential article by George Stigler in 1961.[14] Stigler argued that consumers would benefit from the search for information until the marginal benefits of additional information were just equal to the marginal cost of gathering more data. Information costs contribute to differences in prices and product characteristics across sellers because, although consumers will gather enough information to find a product they are willing to purchase, they will not incur the costs of considering all possible options. Other authors have termed this phenomenon "rational ignorance."[15] The more it costs to obtain additional information, and the smaller the benefits of additional information, the more rational consumers will choose to remain uninformed. Reducing ignorance is simply not worth the costs.

The particular problem that Stigler considered was searching for a lower price, but the result is easily generalizable. The benefit of information is the savings from the possibility of finding a lower-price seller or an offering that is better in some other respect. The cost is the time and effort of gathering information from another seller. As discussed below, information may be acquired through purchase, through the expenditure of time and effort, or from the consumer's past experience. Regardless of how it is obtained, however, information consumes attention.[16] We cannot pay attention to everything, and at some point consumers will decide that they would rather pay attention to family, friends, and the things that make life worthwhile rather than nailing down the facts about one more detail of a potential transaction.

Because finding and using information is costly, consumers must choose which information to seek out. Unsurprisingly, they pay more attention to information about the product features that matter most to them. For example, consumer surveys find that credit card users who almost always pay their balance in full are less aware of the APR and are less likely to check the APR on their statement every month than consumers who sometimes or hardly ever pay in full. Consumers who usually pay in full are much less likely to actually pay finance charges. In contrast, users who sometimes or hardly ever pay their full balance are facing the costs of credit, are more aware of the APR, and are more likely to consider the APR on their statement each

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[14] George J. Stigler, "The Economics of Information," 69 J. Pol. Econ. 213-213 (1961).

[15] Anthony Downs, An Economic Theory of Democracy (Harper) (1957)

[16] Herbert A. Simon, Designing Organizations for an Information Rich World, in In M. GREENBERGER (ED.), COMPUTERS, COMMUNICATIONS, AND THE PUBLIC INTEREST (1971).

month.[17] Similarly, the main reason consumers who usually pay in full opened a new account was to obtain rewards; those who carry a balance did so to make a specific purchase or to rebuild or increase their credit.[18]

Even with costly information, markets can produce competitive outcomes. Some consumers will be informed, whether about price or product characteristics. As long as the informed group is sufficiently large to be worth competing for, their search for information will police the marketplace.[19] Because sellers usually cannot easily discriminate between informed and uninformed consumers in most circumstances, they must offer a competitive price (or competitive terms on other product dimensions) if they wish to compete for the informed buyers.[20] With enough informed buyers, the equilibrium outcome will be the competitive equilibrium, even though many buyers choose not to be informed.

Of course, given the importance of the costs of obtaining information, government actions that reduce the cost of information can improve market performance in maximizing consumer welfare. Standardized measuring systems that facilitate product comparisons, for example, can ease the consumer's task of obtaining information and enhance competition on the measured dimension.[21] As discussed below, this has been the major accomplishment of the Truth in Lending Act, which established the APR as a standardized measure of the cost of credit in consumer credit transactions.

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[17] Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards*, 99 FEDERAL RESERVE BULLETIN 1-36, 22-23 (2013).

[18] Canner and Elliehausen (2013), *supra* note 17.

19 Alan Schwartz, A. and Louis L. Wilde, "Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis," 127 U. PA. L. REV. 630-682 (1979).

[20] Shopping occurs even for the terms of standard form contracts. See, e.g., Howard Beales and Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence,* 21 J. CORP. FINANCE: CONTRACTING, ORGANIZATION AND GOVERNANCE, 157-198 (1995) (Evidence addressing shopping for standardized franchise contracts). See also Barth, J.R., J.J. Cordes, and A.M.J. Yezer, *Benefits and Costs of Legal Restrictions on Personal Loan Markets,* 29 J. LAW & ECON. 357-380 (1986). (Evidence of shopping for personal loan terms). The critical role of marginal consumers in determining the competitive market outcome is discussed in more detail in Howard Beales, *Consumer Protection and Behavioral Economics: To BE or Not to BE?,* 4 COMPETITION POLICY *International* 149-168 (2008).

[21] Howard Beales, Richard Craswell, and Steven Salop, *The Efficient Regulation of Consumer Information,* 24 J. LAW & ECON. 481-539 (1981).

7.2 Seller-Provided Information

Sellers' advertising and other forms of marketing combine for one of the most important sources of information for consumers. The substantial investments that firms make in advertising are best understood as efforts to provide information to consumers. As George Stigler noted, "advertising is an immensely powerful instrument for the elimination of ignorance."[22]

Seller incentives to provide positive information about their products are obvious. There is also a clear incentive to select the information that is of greatest use to the consumer—the information that is most likely to influence consumers' choices. In some cases, such as regulations mandating standardized measurement systems, a disclosure requirement may motivate advertising of useful information. As discussed in more detail below, however, disclosure requirements can effectively increase the costs of providing useful information. In such cases, a disclosure requirement may discourage useful information and motivate sellers to talk about something else.

Generally, information has a greater impact on markets when it is disseminated voluntarily, and in response to consumer demand.[23] With or without disclosure requirements, the effect of information stems from the fact that sellers use information to compete on product characteristics that consumers care about. And, of course, sellers have incentives to tell consumers about product characteristics they may not know about and explain why they should care. Fat and fiber content were frequently disclosed on nutrition labels, but it was advertising addressing the health benefits of diets higher in fiber[24] and lower in fat[25] that led to significant changes in consumption. It is not disclosure requirements that make it easy to locate products that are kosher or halal or organic, because there are none; it is rather the self-identification of such products in response to consumer demand.

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[22] Stigler, *supra* note 14.

[23] This assumes that there are measurements that allow comparison of competing products. See, Beales, Craswell and Salop, *supra* note 21. The market-enhancing impact of Truth in Lending occurred precisely because it provided such a measure.

[24] Pauline Ippolito & Alan Mathios, *Health Claims in Advertising and Labeling: A Study of the Cereal Market*, FTC STAFF REPORT (1989), *available at* http://www.ftc.gov/be/econrpt/232187.pdf.

[25] Pauline Ippolito & Alan Mathios, *Information and Advertising Policy: A Study of Fat and Cholesterol Consumption in the United States, 1977–1990*, FTC STAFF REPORT (1996), available at http://www.ftc.gov/be/consumerbehavior/docs/reports/IppolitoMathios96_fat_long.pdf.

If information markets are to work efficiently, the information they provide must be accurate and reliable. Absent some check, a seller's incentive to overstate the advantages of their offering is straightforward. Intervention to prohibit false or deceptive advertising is therefore essential.

Government intervention, however, is not the sole force for honesty in the marketplace. Many financial services, including credit cards, deposit accounts, and prepaid cards, are likely experience goods, where a consumer can evaluate the quality of the service after using it.[26] Profitability depends on customer retention. Dissatisfied customers are not likely to remain for long. If consumers are misled into purchasing a service that does not deliver as advertised, they are likely to be dissatisfied, and leave. For the same reason, the mere fact that a firm advertises is a source of information about product quality. When sellers depend on repeat purchases, they can signal their quality with investments in advertising.[27] These investments only yield a return if consumers continue to buy the product. Investments in advertising thus act as a bond, which the firm will lose if poor performance leads consumers to stop purchasing the product. Such investments are an important market incentive to ensure that firms provide what they promise.[28] Similarly, a seller's reputation is an intangible asset that is at risk from misleading practices, providing an important incentive for honesty and fair dealing.[29] In a survey asking credit card consumers what factors were important in their decision to get their card, the seller's reputation was second only to card acceptance by merchants, in closed-ended questions, and more often mentioned than interest rates or fees.[30]

Of course, many financial products, such as mortgages, are not frequently purchased. Although the mortgage lender may hope to market other products and services to a borrower, repeat purchases are a less effective market pressure than in the case of frequently purchased items. In the case of mortgages, however, consumers usually have access to independent sources of information who may have repeated experience with a particular lender and know the lender's

[26] Phillip Nelson, *Information and Consumer Behavior,* 78 JOURNAL OF POLITICAL ECONOMY 311-329. (1970) (distinguishing between search characteristics and experience characteristics). As with other information, experiential evaluation of quality is often incomplete, focusing on the characteristics that are most important to the consumer. Nonetheless, market outcomes can be competitive.

[27] Phillip Nelson, *Advertising as Information,* 82 JOURNAL OF POLITICAL ECONOMY, 729-754 (1974).

[28] Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance,* 89 JOURNAL OF POLITICAL ECONOMY 615-641 (1981).

[29] *See* Armstrong, M., *Interactions between Competition and Consumer Policy,* 4 COMPETITION POLICY INTERNATIONAL 97-148. (2008). See also Paul Rubin, *Regulation of Information and Advertising,* 4 COMPETITION POLICY INTERNATIONAL 169-193 (2008).

[30] CONSUMER FINANCIAL PROTECTION BUREAU, ARBITRATION STUDY: REPORT TO CONGRESS, 3-14 (2015).

reputation. As discussed below, most home buyers use a real estate agent, who is likely knowledgeable about financing options. Thus, reputational incentives continue to constrain the lender's behavior. Still other financial products, such as investment advice, are what economists call "credence goods,"[31] where quality cannot be evaluated even after the fact, and where other experts may disagree about quality. Even in these cases, however, theoretical analyses find that market outcomes are efficient as long as either quality is verifiable or providers are liable for poor quality.[32]

One of a seller's key incentives is therefore to satisfy its customers, and to provide the kind of information that will attract customers who will remain with the business. In marketing credit cards, for example, one source reports a rule of thumb that booking a new account costs $275. That account will be profitable only if consumers continue using the card. Attrition rates on credit card accounts are about 15 percent.[33] A card provider, therefore, needs to offer features that consumers want, and inform consumers about those features. If not, consumers will simply leave. The Consumer Financial Protection Bureau's study of arbitration clauses found that if a credit card issuer refused to refund a fee that the consumer had not agreed to, 57 percent of consumers would close the account.[34] Because they are aware of this consumer behavior, banks often offer refunds of unexpected or disputed fees when consumers complain. One Texas bank offered refunds in two-thirds of cases in which a consumer complained.[35] It is simply not worth alienating otherwise profitable customers over disputed fees.

The need for repeat business also drives marketing choices about which information to provide. Because different consumers use credit cards differently, card issuers have an incentive to develop marketing materials that seek to attract the right consumer to the right card. Consumers who pay their balances regularly are likely to be far more interested in rewards for card use and unconcerned about the interest rate. Consumers looking to roll over an existing balance are likely to be far more attuned to the rate and less concerned about other card

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[31] M.R. Darby and E. Karni, *Free Competition and the Optimal Amount of Fraud*," 16 JOURNAL OF LAW & ECONOMICS, 67-88 (1973).

[32] U. Dulleckand R. Kerschbamer, On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods," 44 J. ECON. LIT. 5-42 (2006).

[33] Brian Riley, *New Credit Card Accounts Up but Volumes Remain Flat*, PAYMENTS JOURNAL (2018). Available at https://www.paymentsjournal.com/new-credit-card-accounts-volumes-remain-flat/. Actual data on the cost of acquiring new accounts is closely held information in the industry.

[34] CFPB (2015), *supra* note 30.

[35] Jason Scott Johnston and Todd Zywicki, The Consumer Financial Protection Bureau's Arbitrattion Study: A Summary and Critique, Mercatus Working Paper, Mercatus Center at George Mason University, at 32 (2015).

features. Consumers are quite able to make appropriate choices: In an experiment by a large bank that offered a choice between a card with an annual fee and a lower interest rate or a higher rate with no fee, on average consumers made the cost-minimizing choice. Of course, some consumers made mistakes, but they corrected those mistakes, especially when the errors were large.[36]

Seller willingness to provide information that consumers value is apparent in the marketing of many financial services, even where information is not required. Many providers offer features such as low-balance alerts that are designed to help consumers avoid fees. Others offer apps to monitor credit card transactions for common errors such as a transaction mistakenly submitted twice or a wildly disproportionate tip.

Sellers also have strong incentives to reveal negative information about products because less of a negative feature (e.g., lower fees) is a product benefit. Sellers who look better, therefore, have an incentive to say so. If consumers assume that sellers who are silent are inferior to those who talk about the attribute, there is an incentive for all but the worst product on that characteristic to disclose. This unfolding principle argues that sellers will voluntarily provide even negative product information, as long as competing offerings differ on the characteristic and the characteristic is important to consumers.[37]

Empirically, the evidence is clear that seller-provided information through advertising significantly enhances market performance in maximizing consumer welfare. Much of the evidence comes from studies of the effects of restrictions on advertising. The earliest restrictions studied were also quite broad, prohibiting advertising entirely in a particular market. One of the earliest studies examined the effect of state prohibitions on advertising of eyeglasses, and found that prices for eyeglasses were approximately 25 percent higher in states that adopted such restrictions.[38] Several subsequent studies confirmed this result in markets for optical goods and

[36] Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts*, 4 REVIEW OF CORPORATE FINANCE STUDIES 239-257 (2015). Even some "mistakes" such as paying an annual fee may be rational as a means of limiting the risk of larger mistakes if future borrowing needs are uncertain. For a fuller discussion of the evidence that consumers make appropriate choices about credit cards, see Thomas A. Durkin, Gregory Elliehausen, and Todd J. Zywicki, *An Assessment of Behavioral Law and Economics Contentions and What We Know about Credit Card Use by Consumers,* 22 SUPREME COURT ECONOMIC REVIEW 1-54 (2014).

[37] Sanford Grossman, *The Informational Role of Warranties and Private Disclosure about Product Quality*, 24 JOURNAL OF LAW & ECONOMICS 461-484 (1981). See also Paul Rubin, *The Economics of Regulating Deception,* 10 CATO JOURNAL 667-690 (1991).

[38] Lee Benham, The Effect of Advertising on the Price of Eyeglasses, 15 J. L. & Econ. 337, 344 (1972).

services.[39] Similarly, states that prohibited price advertising of prescription drugs had higher prices,[40] and the introduction of toy advertising to children led to lower toy prices.[41]

Blanket prohibitions on advertising ended when the U.S. Supreme Court extended First Amendment protection to commercial speech. Subsequent restrictions have been more subtle and more varied. Attorney advertising restrictions, for example, varied widely, with some states prohibiting broadcast advertising, some prohibiting pictures or illustrations, and some requiring that advertising be "dignified." States with more restrictions had higher prices for routine legal services.[42] Restrictions on advertising media also raised product prices. The ban on broadcast advertising of cigarettes, for example, led to higher cigarette prices.[43] Similarly, when Quebec, Canada, adopted restrictions on television advertising to children, the result was higher prices for children's cereals in Quebec compared with other parts of Canada; there was no increase in the price of adult cereals that could still advertise.[44]

The ability to advertise tends to lower product prices whether or not advertising actually includes price information. Price advertising has been found to reduce prices for retail gasoline,[45] prescription drugs, and retail liquor stores.[46] But advertising that rarely, if ever, includes price information has also been shown to lead to lower prices, as in the studies of toy advertising, cigarettes, and children's cereals discussed above. Knowing about more of the available alternatives facilitates consumer choice and encourages competition.

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[39] *See, e.g.*, John E. Kwoka, Jr., *Advertising and the Price and Quality of Optometric Services*, 74 Am. Econ. R. 211, 216 (1984); Deborah Haas-Wilson, *The Effect of Commercial Practice Restrictions: The Case of Optometry*, 29 J. L. & Econ. 165, 182 (1986) (finding that "media advertising by optometrists is associated with lower prices").

[40] John F. Cady, Restricted Advertising and Competition: The Case of Retail Drugs 11, 20 (1976).

[41] C. Robert Clark, *Advertising Restrictions and Competition in the Children's Breakfast Cereal Industry*, 50 J. L. & Econ. 757, 759-60 (2007).

[42] John R. Schroeter, Scott L. Smith & Steven R. Cox, Advertising and Competition in Routine Legal Service Markets: An Empirical Investigation, 36 J. Indus. Econ. 49, 59 (1987).

[43] Robert F. Porter, *The Impact of Government Policy on the U.S. Cigarette Industry*, *in* Empirical Approaches to Consumer Protection Economics 447, 459 (Pauline M. Ippolito & David T. Scheffmann eds., 1986).

[44] C. Robert Clark, *Advertising Restrictions and Competition in the Children's Breakfast Cereal Industry*, 50 J. L. & Econ. 757, 759-60 (2007).

[45] *See* Alex Maurizi & Thom Kelly, Prices and Consumer Information: The Benefits from Posting Retail Gasoline Prices (1978).

[46] Jeffrey Milyo & Joel Waldfogel, *The Effect of Price Advertising on Prices: Evidence in the Wake of* 44 Liquormart, 89 Am. Econ. Rev. 1081 (1999).

There is also evidence that the specific information content of advertising claims has significant market impacts. Again, the best evidence comes from studies of the effects of restrictions on advertising. Until the late 1980s, the Food and Drug Administration regarded any claim about the relationship between diet and disease as a drug claim and argued that any such claim made the product a misbranded new drug. In the 1960s, for example, the agency seized Quaker Oatmeal from store shelves because the label included a claim about the relationship between soluble oat fiber and serum cholesterol levels.[47] Some health claims appeared in food advertising, but they were relatively infrequent until claims were also permitted on food labels.

The regulatory environment began to change in 1984, when Kellogg launched an advertising and package label campaign for All-Bran promoting the National Cancer Institute's recommendation that diets high in fiber could reduce the risk of some forms of cancer.[48] Studies on the impact of the campaign found a significant market response. Fiber consumption increased, in part because of changes in purchasing patterns, but also because of changes in the products themselves. The weighted-average fiber content of breakfast cereals had been essentially constant for several years before the campaign began but increased significantly after 1984. There was no significant increase in the fat or sodium content of cereals.[49] Health claims about the relationship between saturated fat and heart disease also became far more common after the health-claim era began, and again there was a significant market impact. Fat and saturated fat consumption had both declined somewhat between 1977 and 1985, but both fell far more sharply after health claims became commonplace.[50]

An important finding from the health-claims studies is that advertising tended to have larger benefits in changing consumption for less educated and disadvantaged consumers than other consumers. In response to health claims about fiber, consumption increases were greatest

[47] *See* John E. Calfee & Janis K. Pappalardo, *Public Policy Issues in Healh Claims for Foods*, 10 J. Pub. Pol'y & Mktg. 33, 36 (1991) (discussing the early history of regulation of health claims).

[48] FDA initially threatened enforcement action against Kellogg but backed down when the FTC and the NCI defended the claim. It suspended its prior policy prohibiting health claims, and in 1990, Congress codified the policy change. The regulatory history is detailed in J. Howard Beales III, Timothy J. Muris & Robert Pitofsky, In Defense of the Pfizer Factors, in THE REGULATORY REVOLUTION AT THE FTC: A THIRTY-YEAR PERSPECTIVE ON COMPETITION AND CONSUMER PROTECTION 83, 84, 90–91 (James Campbell Cooper ed., 2013).

[49] Pauline M. Ippolito & Alan D. Mathios, Fed. Trade Comm'n, Health Claims in Advertising and Labeling: A Study of the Cereal Market, ix-xx (1989); Pauline M. Ippolito & Alan D. Mathios, *Information, Advertising and Health Choices: A Study of the Cereal Market*, 21 RAND J. Econ. 459, 473-74 (1990).

[50] Pauline M. Ippolito and Alan D. Mathios, *Information and Advertising: The Case of Fat Consumption in the United States*, 85 Am. Econ. Rev. 91, 92 (1995); Pauline M. Ippolito & Alan D. Mathios, FTC, Information and Advertising Policy: A Study of Fat and Cholesterol Consumption in the United States, 1977-1990 242 (1996).

among racial minorities and female-headed households.[51] The goal of advertising is to make information easily accessible, and that effect is more important for disadvantaged groups with less access to other information sources. Similarly, studies of restrictions on eyeglass advertising found that in states that restricted advertising, prices were highest for the least educated consumers.[52] Advertising that makes information more easily digestible is therefore particularly important to those who need information the most.

7.3 Markets for Information

Particularly in the internet era, consumers operate in deep and competitive markets for information. In an earlier age, finding disinterested articles or advice about a financial issue required either the coincidence of encountering a relevant article at an appropriate time in the decision-making process, or library research to extract useful material. Today, Google will offer up numerous answers to any question. Searches on nearly any financial question will, of course, yield sellers offering the product, but searches also yield links to objective information sources such as Investopedia and, often, advice from government agencies. The difficulty is not finding information; rather, the problem is choosing how much to search, which information links to pursue, and determining which information is reliable and worthy of attention. Information is readily available, but consumers must decide what information they wish to use.

Increasingly, websites of information aggregators turn up early in the list of Google results. These sites assemble information from a wide variety of service providers, often allow easy sorting of product offerings by key features, and may offer to match consumers with a product that is "best" for them. For example, CreditCards.com organizes data about credit card offers from eight major issuers.[53] Consumers can see a list of card offers by feature (e.g., rewards card, zero percent APR, no annual fee) or browse a list of the "best" cards for a given credit-score range. They also have the option of supplying personal information to allow matching with a particular card that is thought to be appropriate for them or exploring the "best" cards either in general or in particular categories. The site offers "apply now" links that enable the consumer to apply for a product of interest directly.

[51] Ippolito and Mathios, *supra* note 24.

[52] Lee Benham & Alexandra Benham, Regulating Through the Professions: A Perspective on Information Control, 18 J.L. & ECON. 421, 444 (1975).

[53] *See* https://www.creditcards.com/?v1=true

NerdWallet offers similar options for credit cards, but it also includes a broader range of financial products, including various bank accounts; personal, student, and small-business loans; auto and life insurance; and investment services. Each product category includes financial education materials that offer advice about the category, and a more general "money" category provides information on budgeting, paying for college, moving, lowering utility bills, ways to make money, and a career guide.

Other information aggregators range far beyond financial services. Top10.com offers top 10 lists for financial service products, but it also offers lists for various services, including cocktail apps, crowdfunding platforms, and places to buy used textbooks. Similarly, ConsumerAdvocate.org[54] covers numerous financial products, including structured settlements, debt relief services, and cryptocurrency exchanges. The site also offers home and lifestyle product reviews (from mattresses and meal delivery services to kitchen remodeling and car shipping companies), and health product reviews(from blood tests to essential oils and online therapy).

The business models of the information aggregators vary. Some, such as Investopedia, are publishers, supported as publishers have always been by advertising revenue. Although advertising for specific products may be sold based on click throughs, there is little reason to suspect that the need for clicks would skew the editorial content, any more than the need for advertising revenue skews the editorial content of print publications. It is far more likely that the editorial content influences the kinds of products that are interested in advertising on such sites. This model seems to describe NerdWallet as well.

Probably the most common business model among information aggregator sites is receiving a commission or referral fee when consumers apply for or are accepted for a particular offering. For example, CreditCards.com is paid by financial service providers when consumers apply or are approved for an offer. This affiliate referral model is also employed by Top10.com and ConsumerAdvocate.org. NerdWallet also receives compensation through this model. All three aggregators disclose that they receive compensation, and that "this compensation may impact how and where products appear."[55] Although some effect is certainly possible, when a site offers a wide range of products from numerous competing sellers, all of whom compensate the site, there is little reason to believe that financial incentives would significantly distort rankings or recommendations.

[54] *See* https://www.consumersadvocate.org/

[55] The example is from creditcards.com's "advertiser disclosure," reached via a link on the home page. See https://www.creditcards.com/.

Some information aggregators offer comparative information as a complement to other services. Intuit's Mint, for example, lets consumers sign up to view all their financial accounts in one place.[56] It also offers lists of various financial product offerings, including credit cards, personal loans, and certain insurance products. Companies pay to have their products included on the lists. LendingTree's ValuePenguin includes similar lists.[57] Most personal loans listed are offers through the LendingTree website, but the site also offers credit cards, insurance products, and small-business products.

Consumers can also produce information themselves, through shopping competing sellers and comparing their offerings, either online or in person. For many products and services, consumers have prior experience, and perhaps the seller and can rely on what they learned both through the purchase process and through their experience using the product. That experience will enable them to identify, for example, the features of a particular credit card that they liked best, as well as pitfalls they may not have anticipated when the purchase was made initially. Subsequent decisions can take that learning into account.

An important source of information for many consumers is advice from family and friends, giving most consumers access to a broader base of experience. Marketers have long recognized the importance of this "word of mouth" information, and generally regard it as more influential than marketer-controlled information sources.[58]

Today, electronic word of mouth is an increasingly important influence on consumer behavior.[59] Third-party review sites such as Yelp are clear examples of electronic word-of-mouth communication, along with social media review pages and the Bureau's complaint database. Companies often seek to encourage such communication by offering opportunities to post reviews or to like or share content; doing so allows companies to see problems and address concerns that might otherwise circulate on social media without their knowledge. Firms also make investments in reputation management in an attempt to prevent bad consumer experiences from damaging a product or a reputation.

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[56] *See* https://www.mint.com/

[57] *See* https://www.valuepenguin.com/

[58] See Francis A. Buttle, *Word of mouth: understanding and managing referral marketing*, 6 JOURNAL OF STRATEGIC MARKETING 241-254 (1998).

[59] Ismagilova, E., Slade, E.L., Rana, N.P. et al. The Effect of Electronic Word of Mouth Communications on Intention to Buy: A Meta-Analysis. INF SYST FRONT (2019).

Consumers can also purchase advice from disinterested information sources such as Consumer Reports and comparable publications or from a wide variety of financial professionals, including real estate agents, accountants, and attorneys. Indeed, in many of the most complex financial transactions, other professionals are involved. A consumer searching for a new home is likely in contact with a real estate broker who is likely familiar with the pros and cons of various financing options.[60] The broker's primary incentive is to find a deal that will make the consumer happy, generating both a commission and the prospect of future referrals that make the broker happy.

Information has a cost, in time, attention, and effort to use it. No consumer will pursue all available information, because the cost of doing so would far exceed the benefits. There is no evidence that too little information is available, but consumers must choose which information to pursue – with or without disclosure.

7.4 Consumer Behavior and Information Processing

If information is to have an impact, at least some consumers must use it. We are all bombarded with thousands of stimuli every day, and we cannot possibly pay careful attention to each one. The marketing literature on information processing, derived from cognitive psychology, examines in detail the road from an information stimulus to the use of that information. Consumers must be exposed to information, pay attention to it, comprehend it, accept it, and retain it.[61]

The first step in the process is exposure. Whether it is marketing information, required disclosures, or some other information, it must be presented to the consumer in a way that

[60] The National Association of Realtors 2019 Profile of Home Buyers and Sellers found that 89 percent of buyers purchased their home through a real estate agent or broker; 5 percent purchased directly from a builder or the builder's agent. Ninety percent of buyers would use their agent again. Available at https://www.nar.realtor/research-and-statistics/research-reports/highlights-from-the-profile-of-home-buyers-and-sellers#searchprocess.

[61] For a fuller discussion of the information processing literature, see DURKIN AND ELLIEHAUSEN, *supra* note 12, at 53-55. An alternative formulation of the sequence of using information is that consumers must find it, read it, understand it, use it, use it appropriately. *See* OMRI BEN-SHAHAR AND CARL E. SCHNEIDER, MORE THAN YOU EVER WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE, 34 (2014).

consumers can perceive it. Exposure may fail if information is directed to the wrong audience or it becomes available at the wrong time.[62]

A consumer exposed to information then must pay attention to it. Attention may be more likely if the information is seen as having immediate utility, as it might be if it pertains to a purchase or transaction that a consumer is contemplating when exposure occurs. Timing therefore matters; a consumer considering whether to purchase a sedan or an SUV is less likely to attend to information about financing than one who has settled on a vehicle and is seeking the best deal. The message itself also influences the likelihood that consumers pay attention. Many advertising techniques, from catchy jingles to splashy graphics, are devices that seek to attract the consumer's attention.[63]

After exposure and attention, a consumer must comprehend the message. Unfortunately, any message can simply be misunderstood.[64] Comprehension depends in part on the degree of attention to the message; a message that is only partially attended to is less likely to be understood correctly. Comprehension also depends on the clarity and complexity of the information, with a more ambiguous or complicated message less likely to be fully understood. Moreover, comprehension of any message is likely to vary from one consumer to another, if for no other reason than the different backgrounds and experiences of different individuals.

Once comprehended, a message must be accepted. A message may be correctly understood but rejected on the basis of prior experience or a counterargument that strikes the consumer as more persuasive. A message that consumers reject will have little influence on behavior.[65]

Finally, the information must be retained in memory until it is needed. Although long-term memory capacity is nearly limitless, short-term or immediate memory is much more limited.

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[62] See William L. Wilkie, *Affirmative Disclosure at the FTC: Communication Decisions*, 6 JOURNAL OF PUBLIC POLICY & MARKETING 33 (1987).

[63] See e.g. Steven Bellman, Magda Nenycz-Thiel, Rachel Kennedy, Nicole Hartnett, and Duane Varan, Best Measures of Attention To Creative Tactics in TV Advertising, 59 Journal of Advertising Research Sep 295-311 (2019).

[64] See the discussion of misunderstanding in Section E 1 below.

[65] See e.g., Julie A. Edell and Kevin Lane Keller. "The Information Processing of Coordinated Media Campaigns." 26 Journal of Marketing Research 149–63 (1989).

People can retain and process only about seven “chunks” of information at a time.[66] Too much information all at once can easily overwhelm these limits.

An implication of the information-processing approach is that the timing of the provision of information may be critical. Timing affects the likelihood of exposure and attention. Information provided at the time it is wanted reduces the need to store the information in memory for later retrieval; the information can be used at the time it is received. Information provided after a transaction is concluded obviously did not influence the purchase decision, although it may influence evaluation of the transaction and thereby affect future decisions.

The importance of timing has led to interest in “just in time” disclosure. Such a disclosure is one that arrives precisely when the information is needed. A clear example is the low-balance alert that tells consumers both that their account balance is low and that, if they overdraw, they will incur certain fees. Such a disclosure is likely to be far more effective than a generic statement about overdraft fees that is repeated on every periodic statement. On the statement, the information is not timely—consumers must remember it and remember to check their balance regularly. A “just in time” low-balance warning solves both problems.

Although just-in-time disclosure is an important aspirational goal, it is not clear how it could be implemented in regulatory requirements. Much of the information in financial disclosures may be relevant to different consumers at different times. In shopping for a new car, for example, some consumers may first consider the cost of financing at different financial institutions and would find information about the APR useful and relevant. Other consumers may shop for the car first and would be more interested in information about the car and its features. Those consumers might then use the dealer’s financing offer as a baseline for comparison. What constitutes “just in time” is not clear in such circumstances.

The potential value of just-in-time information to consumers implies that policymakers should avoid unnecessary burdens on such disclosures. In particular, it is easy to imagine information beyond the fee and the balance that could be relevant in the case of the low-balance alert (e.g., when and how much is the next regularly scheduled automatic deposit), but a requirement for more fulsome disclosure could prevent the service from getting off the ground in the first place. As discussed more fully below, before the Truth in Lending Simplification and Reform Act, required disclosures led sellers to abandon advertising of interest rates.

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[66] See George A. Miller, *The Magical Number Seven, Plus or Minus Two: Some Limits on Our Capacity for Processing Information*, 63 PSYCHOLOGICAL REVIEW 87-97 (1956). This is one of the most widely cited articles in the psychology literature.

7.5 Disclosure and its Limitations

The solution to problems that may result from incomplete information seems so obvious: Just disclose the needed information to consumers. That has been the widespread policy response whenever there is a realization that some additional fact would have been useful to at least some consumers on at least some occasions. The result has been an unchecked proliferation of mandatory disclosures. Truth in Lending has grown from an original proposal to disclose an effective interest rate and finance charges to a detailed list of 20 items for closed-ended credit in one listing, plus additional.[67] One author described a mortgage-closing package with 49 disclosures spread over 101 pages.[68] Open-end consumer credit requires 31 itemized disclosures.[69] Similarly, the California Retail Installment Sale agreement has grown from an 8x11-inch single page with four disclosures, 743 words, and two signature lines in 1961 to a document known colloquially as the bedsheet, with 16 disclosure boxes, 2,051 words, and eight.[70]

Extensive disclosure of all potentially relevant details does not solve the problem of how much to invest in acquiring information. It addresses, at best, only exposure, the first step in the information processing that is necessary if a consumer is going to use the information. Instead, extensive disclosure simply transforms the problem of finding information into one of how to allocate attention to the abundance of details. It seems safe to say that no one decides about refinancing a house by carefully evaluating all 49 disclosures, and no one chooses a credit card based on carefully weighing the 31 items that must be disclosed. Attention is scarce, and there are far more attractive things to pay attention to. "Even experts helping people invest for retirement used an average of just six of the many variables."[71]

Again, differences in the types of information sought by different consumers are significant. For example, nearly two-thirds of credit card users who almost always pay their balance in full and opened a new account found the account opening disclosures not very or not at all useful. In

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[67] DURKIN AND ELLIEHAUSEN (2011), *supra* note 12, p. 234-235.

[68] BEN-SHAHAR AND SCHNEIDER (2014), *supra* note 61, p. 22.

[69] DURKIN AND ELLIEHAUSEN, *supra* note 12, at 236.

[70] BEN-SHAHAR AND SCHNEIDER, supra note 61, at 24-25.

[71] Id. at 102.

contrast, among those who carry a balance, 85 percent thought the information was very or somewhat useful.[72]

Despite its attractions, disclosure has important limitations as a solution to information problems. Like any other communication, disclosures may be misunderstood. Disclosing too much information can results in information overload, leading consumers to ignore information and be less informed, not better informed. Disclosures also displace other information that may be more valuable. And compliance is complex and costly.

7.5.1 Disclosures May be Misunderstood

Any communication can be misunderstood. That commonplace fact of daily life applies with equal or greater force to marketing communications and the required disclosures that seek to provide additional information. If enough recipients are exposed to a message and pay attention to its content, some of them will misunderstand, in a manner that may be completely wrong and may be very different than what was intended. Academic studies of brief communications have examined misunderstanding of both advertising and editorial content of print and video communications, and found that 20 percent to 30 percent of the audience misunderstands some aspect of the communication. Although advertisers devote considerable resources to determining how best to convey their message, the level of misunderstanding was not significantly different for advertising and editorial content.[73]

One source of misunderstanding is the inherent ambiguity in language, particularly qualitative language. The same word may mean different things to different people. In a study of business communications with college students, subjects were asked to assign a numerical probability to generic probability terms. "Always" was interpreted, on average, as occurring around 90 percent of the time but with a standard deviation of around 15 percent. "Never" was interpreted as 8 percent to 14 percent in three different groups, with standard deviations of 15 percent to 25 percent.[74] In a study in a medical context, only 80 percent of patients agreed that "certain" meant 100 of 100 people; only 67 percent agreed that "never" meant 0 of 100 patients. Patients

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[72] Canner and Elliehousen, *supra* note 17, at 28.

[73] *See* Jacob Jacoby et al., Miscomprehension of Televised Communications 64 (1980) (noting the statistics of miscomprehension for television viewers). For print communications, *see* Jacob Jacoby & Wayne D. Hoyer, The Comprehension and Miscomprehension of Print Communications (1987).

[74] Edward C. Brewer and Terence L. Holmes, *Obfuscating the Obvious: Miscommunication in the Interpretation of Common Terms*, 46 J. BUSINESS COMMUNICATION 480-496 (2009). Results are presented in Table 2, p. 490.

assigned numerical probabilities to complications described as "unlikely" that were three times higher if the complication was minor than if the complication was a major one.[75]

In the business communications study, "probably," "usually," and "often" were all assigned about the same numerical probability, generally around 60 percent, with a standard deviation of about 15 percent. To take a specific example, the mean probability of "probably" was 61 percent. A person who interprets the word in a way that is one standard deviation above the will be describing a probability of 78 percent. If the recipient assigns a meaning that is one standard deviation below the mean, the recipient will *understand* a probability of 44 percent.[76] Studies have also found that recipients assign higher numerical probabilities to chance terms if the chance is for something that is good for them personally than if it is good for others; they assign a lower probability if the risk is an unpleasant event for them than when the risk applies to others.[77] "One study found doctors' interpretations of 'likely' ranging 'from 25 to 75 percent,' and another study found interpretations of 'very likely' ranging 'from 30 to 90 percent.' "[78]

Time words are similarly ambiguous. In the business communications study, the one standard deviation range of hours meant for a request to be completed "ASAP" was from 27 to 72 hours. "Right away" seems to convey more immediacy, with average times of four to nine hours, but the standard deviations are huge, 15-20 hours.[79]

An additional problem for consumer comprehension is that different disclosures may define certain terms differently. Different regulations include "days," "business days," and "calendar days" that differ in how they count weekends and holidays (and which holidays matter). Even when regulations use the same term, such as "business day," they may have different definitions. Regulation Z even has different definitions of a business day depending on which section of the regulation is at issue.[80] If a business day has a different definition in different disclosures, consumer misunderstanding of one or the other is nearly inevitable.

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[75] Kimberly Koons Woloshin, Mack T. Ruffin, and Daniel W. Gorenflo, *Patients' Interpretation of Qualitative Probability Statements*, 3 ARCH. FAM. MED 961-966 (1994).

[76] Brewer and Holmes, supra note 74, Table 2.

[77] Tim Smits and Vera Hoorens, *How Probable is Probably? It Depends on Whom You're Talking About*, 18 J. BEHAV. DEC. MAKING 83-96 (2005).

[78] BEN-SHAHAR AND SCHNEIDER, supra note 61, at 160.

[79] Brewer and Holmes, supra note 74, Table 2.

[80] See 12 C.F.R. 1062.2(a).

Given the inherent difficulties of communication, it should not be surprising that disclosures are often not fully understood. When consumers misunderstand the disclosure or its significance, the result may be worse decisions, not better ones. Examples of such disclosures are numerous. A study of college students' perceptions tested comprehension of three credit card disclosures, scoring one point for each disclosure that was correctly understood. Across a variety of conditions, the highest value for the sample average total score was 1.71, implying that the average college student did not comprehend slightly more than one of the three disclosures.[81] Similarly, an experimental study of mutual fund cost disclosures concluded that "cost information supplied in the ads appears to be either ignored or misunderstood."[82]

Incomplete understanding of disclosures can lead to worse decisions, not better ones. The Federal Trade Commission tested improved disclosures under the Real Estate Settlement Procedures Act (RESPA) that included information about the yield spread premium. The study asked consumers to compare the disclosures for two different mortgages and choose the lowest-cost offer. When the loans had different costs, consumers were significantly less likely to choose the low-cost mortgage. When the loans had the same cost, participants who received the yield spread premium disclosure were less likely to recognize that the cost was the same. Moreover, most participants believed that broker loans, which included the disclosure, were more expensive than direct loans from the lender, where there was no disclosure, even when the total cost of the loans was the same.[83] Clearly, more information did not lead to better decisions.

Comprehension testing of disclosures can help to assure that consumers understand the message. In the TILA-RESPA Integrated Disclosure (TRID) rulemaking, the Bureau did extensive work to improve the layout and wording of disclosures to enhance comprehension. But understanding is not enough. Consumers must use the disclosures to make a decision, and even if they understand each item individually, and as discussed in the next section, more information may degrade choices rather than enhance them. Better decisions, such as correctly identifying the lowest-cost mortgage, tested in a context where the answer is clear, are the ultimate evidence of whether disclosures work.

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[81] Veronica Thomas, Kendra Fowler, Richard H. Kolbe, The Implications of the FTC's Clear and Conspicuous Standards for the Communication of Credit Card Information to Young Consumers, 16 JOURNAL OF FINANCIAL SERVICES MARKETING 195 (2011), at Table 6.

[82] Beth A. Pontari, Andrea J. S. Stanaland, Tom Smythe, Regulating Information Disclosure in Mutual Fund Advertising in the United States: Will Consumers Utilize Cost Information?, 32 J. CONSUM. POLICY 333 (2009).

[83] James M. Lacko and Janis K. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment,* BUREAU OF ECONOMICS STAFF REPORT (2004), available at https://www.ftc.gov/sites/default/files/documents/reports/effect-mortgage-broker-compensation-disclosures-consumers-and-competition-controlled-experiment/030123mortgagefullrpt.pdf.

7.5.2 Too Many Disclosures Result in Information Overload

As described above, extensive disclosures accompany even relatively simple decision tasks such as choosing a credit card provider. One of the premises of these disclosures is that more information will enhance consumer decisions about which product or provider to choose. The extensive academic literature on information overload argues that more information does improve decisions, but only up to a point. "If further information is provided beyond this point, the performance of the individual will rapidly decline."[84] Additional information will not be integrated into the decision. Instead, it will confuse recipients, distort their ability to set priorities, and make it more difficult to recall other relevant information that should be considered. The result is stress, and a poorer quality decision.[85] Rather than reducing the costs of information, and thereby increasing information use, excessive disclosures may actually reduce information use and result in worse consumer decisions.

Information overload results from a mismatch between information-processing requirements and information-processing capacity. Processing requirements focus on the amount of information that *must* be integrated in order to make a decision. Processing capacity refers to the amount of information that a recipient *can* integrate in a given amount of time. When processing requirements exceed capacity, the result is information overload.[86]

One way to think about information overload is from the perspective of information costs.[87] Adding more information will increase the cost of using that information because consumers must read and understand the entire message to find the items in which they are interested. If consumers decide that the information is not worth the effort, they may simply ignore the message. Offered an encyclopedia to answer a simple question, consumers may simply decide that the answer is not that important after all. The result may be more information in a disclosure but less information actually received and understood by the consumer. As discussed

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[84] Martin J. Eppler & Jeanne Mengis The Concept of Information Overload: A Review of Literature from Organization Science, Accounting, Marketing, MIS, and Related Disciplines, 20 THE INFORMATION SOCIETY 325-344, 326 (2004)

[85] Eppler & Mengis (2004), supra note 84.

[86] Eppler & Mengis (2004), supra note 84.

[87] *See* Joseph P. Mulholland, Summary Report on the FTC Behavioral Economics Conference (2007) *available at* https://www.ftc.gov/sites/default/files/documents/reports/summary-report-ftc-behavioral-economics-conference/070914mulhollandrpt.pdf.

above, a seller's market incentive is to provide easily usable information that is relevant to most consumers; the regulator's incentive is to provide any information that some might find useful.[88]

For purposes of considering disclosures, one relevant cause of information overload is the information itself. Information-processing capacity is higher, and information overload less likely, when information is concise, consistent, and comprehensible. In contrast, information that is uncertain, ambiguous, or complex is more difficult to process.[89]

The person and the task also affect the likelihood of information overload. Consumers differ in their innate ability to process information to some extent. Learned skills and experience in dealing with a particular type of information also reduce the risk of information overload; a skilled financial practitioner is far less likely to be overwhelmed than a consumer facing a complex financial decision for the first time. Individual motivation to understand and use the information also matters. Routine tasks and less complex tasks reduce information load, and the likelihood of overload.[90]

Different information cues effectively compete. The more salient ones tend to undermine the less salient ones. Adding irrelevant cues can mislead consumers to ignore or misunderstand relevant ones.[91] That was certainly the result in the study of yield spread premium disclosure discussed above. Consumers receiving disclosures containing the yield spread premium were less likely to identify less expensive loans than consumers who received otherwise identical disclosures without the yield spread premium. Identifying, understanding, and remembering relevant information is itself a difficult task, but reasoning with that information is an even more challenging cognitive process.[92]

There can be little doubt that current disclosure requirements often result in information overload. The California bedsheet, the lengthy list of Truth in Lending disclosures, and the mortgage settlement package described at the beginning of this section far exceed any plausible estimate of information processing capacity. Rather than informing, they may serve primarily to make a financial decision that many consumers would find intimidating in the first place even more opaque and forbidding.

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88 BEN-SHAHAR AND SCHNEIDER, supra note 61, at Chapter 6, The Politics of Disclosure.

89 Eppler & Mengis (2004), supra note 84, at 331.

90 Eppler & Mengis (2004), supra note 84, at 331.

91 BEN-SHAHAR AND SCHNEIDER, supra note 61, at 101.

92 BEN-SHAHAR AND SCHNEIDER, supra note 61, at 103.

Faced with information overload, consumers have a number of common reactions. Recipients tend to become highly selective about what information they consider, ignoring large amounts of information. They have increased difficulty relating details to the overall picture and the overall decision. They need more time to decide—and they make worse decisions. As one review noted, "...there is wide consensus today that heavy information load can affect the performance of an individual negatively (whether measured in terms of accuracy or speed)."[93]

Regulatory requirements should constantly consider the risks of information overload. If the goal is better consumer decisions, too much disclosure may make matters worse. Information should be provided in a convenient format, but better formatting is not enough. Most important, information that is delivered should be high value, with a clear relationship to the decision that the consumer confronts.[94] Instead, we have disclosures that fail as literary works that motivate consumers to read. "Graceless sentences, dubious grammar, and vulgar syntax rule. The story is plotless, lifeless, humorless, endless."[95] The standard of providing high-value information clearly relevant to the decision at hand is surely not met by many, if not most, of the long list of items that must be disclosed under Truth in Lending requirements, let alone in privacy policies.

Behavioral economists have identified a somewhat similar phenomenon as choice overload. Backed by some experimental evidence, they argue that, faced with "too many" choices, consumers may decide not to choose at all. In effect, too many options can be paralyzing. So why aren't Walmart superstores, which offer more than 150,000 choices, filled with paralyzed shoppers unable to make decisions? It is because Walmart and other retailers have strong market incentives to organize the options to facilitate decision making, effectively highlighting the more relevant alternatives.[96]

As discussed above in the section on seller-provided information, sellers have incentives to do the same with information: to provide the information that consumers consider relevant in a readily digestible fashion. Disclosures required for a new checking account are elaborate and complex, but many banks, covering half of U.S. deposits, have adopted a disclosure summary to make the information-processing task more manageable. Unfortunately, the summary itself is

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[93] Eppler & Mengis (2004), supra note 84, at 331.

[94] Eppler & Mengis (2004), supra note 84, at 334.

[95] BEN-SHAHAR AND SCHNEIDER, supra note 61, at 77.

[96] See the discussion in J. Howard Beales III, *Behavioral Economics and Credit Regulation*, 11 J.L. Econ. & Pol'y 349 (2015).

another form on the pile because the required disclosures must still be provided.[97] Moreover, providing a summary runs the risk of being accused to trying to obscure the require disclosures, rather than emphasizing them. Information aggregators are also striving to provide consumers with relevant, digestible information. Regulatory requirements to provide information that may be of little relevance to most consumers undermine these attempts to make complexity more manageable.

Mandatory disclosures provide uniform information for heterogeneous products to heterogeneous consumers. The most useful information, however, may vary with the nature of the transaction. For example, APR and finance charge are not very useful in mortgage transactions, where the contract interest rate and closing costs are the key variables, but dollar finance charge information may be the most useful information in considering short-term, small-dollar loans. The APR for short-term and small-dollar loans may even be misleading.[98]

As discussed above, consumers often use financial products differently, and are therefore interested in different product features. Many consumers pay off their credit card balances in full every month, and therefore have little interest in details about the APR. Nevertheless, the first lines of information in the Schumer box provide the APR, the balance transfer APR, the cash advance APR, and any other APRs that may apply in other circumstances. Even that information may not apply if, as is often the case in application disclosures, the rate depends on the creditworthiness of the customer. Other consumers are interested in the rewards that they might receive for using the card, and the Schumer box tells them nothing of interest. Instead, it provides information about other fees that may be relevant eventually, such as late fees, as well as fees such as foreign currency conversions and foreign transaction fees that may never be relevant for most consumers. Moreover, it seems likely that exceedingly few decisions, if any, about which card to apply for are driven by differences in any of these fees. Markets tailor information to the audience most likely to find that information of interest; uniform required disclosures cannot do so.

Consumers likely differ in the information they seek about other credit products as well. In searching for an auto loan, a credit-constrained consumer may be most interested in the monthly payment and the required down payment. A consumer who can borrow as much as

[97] Novantas Research, Understanding Consumer Choice: A Review of Consumer Overdraft Behaviors (2015), at 18.

[98] *See* WALLACE P. MORS, CONSUMER CREDIT FINANCE CHARGES: RATE INFORMATION AND QUOTATION (1965). For example, a payday loan for $100 that costs $15 will only cost $15 if it is repaid on time, not the $300 that an APR of 300% might suggest.

desired is more likely to care about minimizing the total cost of credit over the expected life of the loan.

Too much information is also the inevitable consequence of the fact that disclosure requirements are almost never removed. There may have been a time when the minimum finance charge was an important differentiator between competing card products, but that is hardly the case today. Nonetheless, the minimum finance charge remains a prominent part of the Schumer box. It is difficult to imagine that the total of payments was ever useful information on a 30-year mortgage, but there it is in the Truth in Lending disclosures. It likely does not have much utility for an auto loan either, but again, it is part of the required disclosures. Some states require disclosure that married women can ask to have their credit reported in their own name. That information may have been vital at one time, but the disclosure is clearly an anachronism when credit reports are routinely compiled on individuals, not households. The problem is gone, but the disclosure is not. Similarly, there is serious doubt about the continued utility of the required disclosure on any application asking for "income" that the applicant need not disclose income from alimony, child support, or separate maintenance payments if they do not want that income considered.[99] And surely, as automated teller machines evolved, the statutory requirement for a physical placard disclosing out-of-network fees was obsolete long before Congress repealed the requirement in 2012.

Obsolete disclosures highlight an important tension in disclosure requirements between specific regulatory requirements and more flexible, principles-based approaches to what must be disclosed. Regulated entities often value certainty: They simply want to know what they must do to comply, and precisely how to do it. Consumer advocates often fear that required disclosures might be hidden, or lack sufficient prominence to gain the consumer's attention. Both desires often lead to detailed, prescriptive requirements, including in many instances specific requirements for font size and particular formatting, such as disclosures in ALL CAPS or in **boldface type**. Without careful testing, formatting requirements may actually make things worse. An experimental study of contract disclosures that were in all caps found that older subjects were significantly less likely to understand the disclosures than those who read the same disclosure in normal text.[100] Unfortunately, such requirements are very difficult to change, particularly when they are written into statutes. Moreover, font requirements written with the printed page in mind may make little sense when translated to a smartphone.

[99] 12 C.F.R. 1002.5 (d) (2).

[100] YONATHAN A. ARBEL AND ANDREW TOLER, ALL-CAPS, SSRN 3519630 (2020).

Marketers routinely change their communications because of the well-known phenomenon of wear-out—if the same message is repeated the same way over and over again, consumers will learn to tune it out. If legislators must specify disclosure details, they should leave regulators the flexibility to determine that a particular disclosure or particular formatting requirement is no longer necessary or appropriate. And regulators should periodically examine the mass of required disclosures with a sharp eye toward eliminating those that contribute more to information overload than they add to consumer enlightenment.

If disclosures are providing useful information, they will favor some firms over others because they look better on the disclosed attribute. Firms with an advantage have every incentive to develop better ways to convey that information to consumers, and therefore to devise disclosures that may do exactly that. Moreover, even if a particular disclosure regime is perfect in every detail at the time it is adopted, changes in products and in markets as new products emerge will likely also change the best way to disclose the information. Changes may make some disclosures irrelevant or may create the need to revise disclosures to avoid conveying a misleading impression to consumers as they consider a new product using disclosures designed with a different product in mind.

In this regard, the Bureau's recent decision to establish a trial disclosure sandbox is a step in the right direction. The sandbox allows firms to apply for a waiver to test possible improvements in disclosure content, format, or delivery.[101] Provided the participation conditions are not unreasonably burdensome, the sandbox offers a real opportunity to build a more flexible disclosure regime better attuned to consumers' needs. Not all experiments will succeed, but the monitoring requirements that are part of the sandbox should provide clear evidence if there is a need to change course.

7.5.3 Displaced Information

Many disclosures, such as those accompanying a mortgage, are delivered to the consumer in separate documents. There are, of course, costs of printing and distributing such disclosures, along with the costs of determining what must be disclosed. And, as discussed in the previous section, disclosures may distract consumers from other information that is more important to them, resulting in worse decisions than would otherwise occur. Disclosures add to the information confronting the consumer, however, and do not directly displace anything.

[101] Links to the policy and the application can be found at https://www.consumerfinance.gov/policy-compliance/innovation/trial-disclosure-program/.

Other disclosures, however, displace information that would otherwise be available to the consumer. This phenomenon is most obvious with advertising disclosures, where time and space devoted to the disclosure cannot be used for other purposes. In purely monetary terms, these costs can be substantial. In 2018, the average price of a 30-second prime-time television advertisement on the top four national networks was $127,000, implying that disclosures cost more than $4,000 per second.[102] In print advertising, even blank space has value, because it helps to set off the relevant portions of the message and enhance attention and readability. Cluttering advertisements with required disclosures should be avoided unless the added information is truly important to an informed choice for most consumers.

For consumers, too many disclosures produce information overload, effectively leading to consumers who are less informed. For sellers, excessive requirements produce information avoidance—sellers choose to talk about product characteristics that are less burdened with required disclosures. That was exactly the effect of the original advertising disclosure requirements in the Truth in Lending Act: "Upon the advent of Truth in Lending, for instance, most creditors simply stopped advertising interest rates."[103] The reduced disclosure requirements that resulted from the 1980 Truth in Lending Simplification Act made present-day credit advertising feasible.

Requiring too much information can effectively prohibit advertising because there is no feasible way to satisfy the requirements. For many years, that was the case with direct-to-consumer advertising of prescription drugs on television. The requirement to provide a "brief summary" of prescribing information could be satisfied in print advertising by purchasing roughly an extra page of space, but it could not be met in television advertising.[104]

Less dramatic disclosure requirements can also steer advertising in different directions, as the experience with health claims for foods clearly demonstrates. When the Food and Drug Administration (FDA) first approved specific health claims for foods (effective in 1993), the

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[102] Calculated from price data in Jeanine Poggi, Here's How Much it Costs to Advertise in TV's Biggest Shows, AdAge (October 2, 2018), available at https://adage.com/article/media/tv-pricing-chart/315120. The rationale for estimating disclosure costs based on the time or space consumed is explored more fully in Beales, Craswell, and Salop, *The Efficient Regulation of Consumer Information*, 24 JOURNAL OF LAW AND ECONOMICS 491 (1981).

[103] Gerald J. Thain, Credit Advertising and the Law: Truth in Lending and Related Matters, 1976 WASH. U. L. Q 257, 275 (1976).

[104] *See* Margaret Gilhooley, *Heal the Damage: Prescription Drug Consumer Advertisements and Relative Choices*, 38 J. Health L. 1, 17-18 (2005). Rather than revise the rules, the FDA issued a Guidance Document that allowed broadcast advertising without including the brief summary. *See* Guidance for Industry on Consumer-Directed Broadcast Advertisements, 64 Fed. Reg. 43,197, 43,197-98 (Aug. 9, 1999).

rules included detailed information about the particular diet-health relationship, along with "model claims" written by FDA that provided detailed information, such as who was most at risk for the particular disease and what other risk factors were relevant. Many advertisers apparently believed that an advertisement must include all this information. The result was a sharp decline in the incidence of health claims, from 11 percent of all magazine food advertising in 1989 to less than 3 percent in 1992-1994. Claims about heart disease and serum cholesterol fell from 8.2 percent of all advertising in 1989 to zero in 1994. When the FDA clarified in 1995 that advertisers need not use the model claims as long as claims were not misleading, health claims rebounded, reaching 8 percent of ads by 1997; serum cholesterol claims rebounded to 4 percent.[105]

Current disclosure requirements for financial services advertising do not appear nearly as burdensome as the short-lived "model claims" regime for health claims, although, as noted above, the requirements in the original statute led to substantial reductions in interest rate advertising. The utility of current disclosures, however, is highly questionable. It is difficult to imagine that very many consumers can read the fine-print television disclosures of the other terms of a "0% APR, offer, that they remember any of those details, or that those details, pertaining to a hypothetical consumer who may be "well qualified" or "approved" in a hypothetical transaction are in any way useful in making a decision. These are disclosures that may satisfy regulatory requirements, but they do little to assist consumers.

Of course, consumers need to understand the basic terms of the transaction before it is consummated. Advertising, however, offers options for consideration, not the fully specified details of a purchase or lease for a complex product and a complex transaction. "Click for details" seems like exactly the right way to make such information available in online advertising,[106] because consumers can access the information when they move from considering options to considering a specific offer. Attempting to provide all such details in conventional media advertising, however, serves no useful purpose.

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[105] *See* Pauline Ippolito & Janis Pappalardo, Advertising Nutrition & Health: Evidence from Food Advertising 1977-1997 E-8 to -11 (2002) (providing detailed data on the incidence of various health claims).

[106] Regulators are often concerned that "too few" consumers will actually click for details. But consumers do click when they are interested. Even low click-through rates do not mean that consumers are not getting the information they need. Search advertising is highly profitable for advertisers, for example, but the click-through rate over the year ending in the first quarter of 2020 was a maximum of 2.88 percent. And only 1.55 percent in the first quarter of 2020. Display advertising click-through rates are substantially lower. See https://www.smartinsights.com/internet-advertising/internet-advertising-analytics/display-advertising-clickthrough-rates/. Moreover, consumers may make several visits to a website before making a decision. One source reports that the lag between first click and conversion averages 3.5 days. See https://neilpatel.com/blog/what-is-the-optimum-number-of-clicks-before-conversions-start-happening/.

7.5.4 Compliance

From the regulator's perspective, disclosures are often a relatively cheap solution. Other than writing and enforcing the rules, they cost the government nothing.[107] Compliance, however, is a different matter. Microsoft Word counts more than 380,000 words of "complicated legalese"[108] in the 2013 version of Regulation Z. Simply reading the rules is itself a major undertaking, let alone understanding their implications, the obligations they impose, how they might affect various products that a financial institution offers, and the details of what compliance requires.

These are essentially fixed costs, largely independent of the size of the organization, and they create a cost disadvantage for smaller institutions, which must spread the costs over a smaller base. The fact that costs per account or other measure of output are higher for smaller institutions is well documented in the literature. Studies of initial compliance costs with the Equal Credit Opportunity Act (ECOA), the Electronic Fund Transfer (EFT) Act, and the Truth in Savings Act all find evidence of higher average costs for smaller financial institutions. Average costs of ongoing compliance have also been found to be higher for the EFT Act, Truth in Lending, the ECOA, the Community Reinvestment Act, the Bank Secrecy Act, and the Real Estate Settlement Procedures Act.[109] A more recent study of all compliance costs at community banks (assets under $10 billion) using survey data from 2015-2017 found that compliance costs were 9.8 percent of total noninterest expenses for the smallest institutions (less than $100 million in assets), declining to 5.3 percent for the largest category examined ($1 billion to $10 billion in assets).[110] The survey attributed 21.2 percent of compliance costs to TILA, RESPA, and Regulation Z; 12 percent to deposit account compliance; 8 percent to the Qualified Mortgage rules; and 6.7 percent to Ability to Repay rules.[111]

Much of the complexity of Truth in Lending regulation stems from two fundamental conceptual problems that are inherent in the disclosure scheme. The first is what has been termed the

[107] BEN-SHAHAR AND SCHNEIDER, *supra* note 61, at 145.

[108] DURKIN AND ELLIEHAUSEN, *supra* note 12, at p. 9.

[109] The relevant studies are reviewed and reported in Greg Elliehausen, *The Cost of Bank Regulation: A Review of the Evidence*, FEDERAL RESERVE BOARD, STAFF STUDY No. 171 (1998).

[110] Drew Dahl, Jim Fuchs, Andrew Meyer, and Michelle Neely, *Compliance Costs, Economies of Scale and Compliance Performance*, DIVISION OF BANK SUPERVISION, FEDERAL RESERVE BANK OF ST. LOUIS, figure 3 (2018). Available at https://www.communitybanking.org/~/media/files/compliance%20costs%20economies%20of%20scale%20and%20compliance%20performance.pdf.

[111] Dahl, Fuchs, Meyer, and Neely (2018), *supra* note 110, figure 1.

outlay issue[112]—which costs of concluding a transaction are part of the cost of credit, and which are costs attributable to other aspects of the purchase? In some instances, the separation is straightforward. It is easy to say, for example, the voluntary credit insurance purchased at the time of the transaction is a separate purchase and not part of the cost of credit. Fundamentally, however, credit is often part of a joint purchase—purchase of a car, a house, or consumer goods—paid for over time. Like any other joint production problem, the allocation of many of the costs of the combined purchase to one component or the other is fundamentally arbitrary. The problem is perhaps clearest in purchasing a car. What matters to the consumer is the total cost of the car and the credit, but shifting costs between "credit" costs and "automobile" costs is relatively easy, especially when the dealer also provides the financing, and very hard to regulate. Many parts of Regulation Z proceed by example, identifying costs that are, and are not, part of the cost of credit. Even if the list is completely comprehensive at the moment it is enacted, the categorization of fees creates incentives to develop new or different fees that can make the disclosure look "better" to the consumer. When a new example arises, as it inevitably will, proper application of the rule is both complex and uncertain, and private plaintiffs have strong incentives to argue that it should have been resolved differently. The result has been a continuing cycle of regulatory change, market changes, and a new round of regulatory changes, with a new wave of compliance burdens. The benefit to consumers is elusive, at best, who may do just as well choosing a loan term that fits their budget and purchasing the deal with the lowest monthly payment.

A second conceptual issue is that the "true" cost of credit depends on unknown future events.[113] The issue is most apparent with credit cards, where the cost of credit depends, among other things, on the extent to which the consumer taps the available credit and whether he or she pays off the balance or revolves it. Similarly, the true APR on a mortgage with points will change depending on whether, or when, the consumer sells the property or refinances the loan. And of course, with variable interest rates on both credit cards and mortgages, future interest rate changes may have an important influence on the total cost. We can make assumptions to do the required calculations—that the 30-year fixed-rate mortgage will be paid off according to the contract and not before—but such assumptions are both arbitrary and wrong for many of the consumers the disclosure is supposed to benefit.

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[112] For a more detailed discussion of the outlay issue, *see* DURKIN AND ELLIEHAUSEN, *supra* note 12, at 88-95.

[113] For a more detailed discussion of the unknown future events issue, see DURKIN AND ELLIEHAUSEN, *supra* note 12, at 95-106.

Policymakers need to rethink Truth in Lending disclosures from the ground up. The starting point should be a careful consideration, based on consumer research, of the information that most consumers need most of the time to make a decision about a particular form of credit. Consumers need access to the details of the credit arrangement, but that is a more appropriate role for the contract than for disclosures. Disclosures should highlight the most important elements of the transaction. A disclosure that repeats the contract is likely to meet the same fate as the contract itself, remaining unread until a term becomes relevant.

For closed-ended credit, it would seem that consumers need five essential pieces of information: the annual percentage rate, the finance charge, any cash due at closing, the periodic payment, and the amount and term of the loan. This approach leaves the unknown future events question to consumers themselves, who must take into account their own future plans and circumstances with or without disclosure. Regulatory hair splitting will not make the decision any easier for consumers.

For open-end credit, it would seem that the key information is the contract interest rate, again defined and disclosed in a standardized fashion, and any regular, recurring fixed fees that a consumer must pay, such as an annual or monthly fee for use of the line of credit.

7.6 The Future of Disclosures

Evaluating disclosures requires identifying the purpose of the disclosure. Our focus in this section is on disclosures intended to provide additional information that may be useful to consumers facing purchasing decisions, and we do not specifically address other types of disclosures.

We recognize, however, that there are other appropriate uses of disclosure. Some disclosures are intended to reduce the extent to which consumers might take away a misleading message from a marketing communication. These disclosures aim to remedy or prevent deceptive practices from misdirecting consumer choices. By their nature, they are idiosyncratic, with the disclosure details depending on the particulars of the claim that provoked the need for clarification or limitation.

Other disclosures may serve primarily to document the details of a transaction. In a mortgage transaction, for example, consumers likely need a detailed listing of various charges to determine which fees are tax deductible, and ultimately to determine correctly their gain or loss when the property is sold. Similarly, the itemized list of transactions on a credit card statement serves to document where the money went for purposes of budgeting, and to enable the consumer to identify incorrect or inappropriate charges. Neither type of disclosure is intended to influence purchasing decisions.

Instead, our focus is on recurring disclosures that provide additional information. Truth in Lending is the prototypical example of such a disclosure related to financial transactions. In other contexts, nutrition labels, gas mileage information, and energy efficiency levels are examples of this type of disclosure.

7.6.1 The Need for Clear and Realistic Goals

Controlling information overload requires careful attention to which disclosures are really necessary, and really useful to consumers. As we noted above, once adopted, disclosures tend to last forever, even if the problem they are addressing does not. Assessing the continued utility of a particular disclosure, however, requires a clear picture of the goals it was adopted to accomplish.

Disclosure is a valuable regulatory tool, but it is not the answer to all consumer protection problems. When disclosures are required, it should be with a clear, and articulated, goal in mind. Too often, however, disclosures have been adopted for a wide variety of reasons, in the belief that they will accomplish tasks for which there is little or no evidence that they are an appropriate tool. As noted earlier in this chapter, Truth in Lending requires many disclosures, but somewhat surprisingly, it has more goals than disclosures. Durkin and Elliehausen's study of Truth in Lending identified 38 distinct goals, grouped into eight categories, ranging from specific credit market goals to general philosophical and educational goals.[114] For open-end credit, Durkin and Elliehausen's list of required disclosures is "only" 31 items. A statute with so many "goals" is unlikely to accomplish them all and offers no guidance on resolving conflicts between goals in specific circumstances. The NCCF identified a set of goals or "functions" limited to the shopping function, the descriptive function (i.e., the choice between credit and either deferral or payment from liquid assets), and the economic stabilization function (consumer could not respond to lower interest rates in a recession if they were not aware of the rate),[115] but the problem of conflicting goals remains.

Disclosure is well adapted to addressing problems that stem from high costs of obtaining information, but only if it is successful in reducing those costs. As discussed at the beginning of

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[114] *See* DURKIN AND ELLIEHAUSEN, *supra* note 12, at 173-174.

[115] *See* the NCCF Report (1972), *supra* note 1, at 171-174.

this chapter, if it is cheaper to acquire information, consumers will acquire and use more information. Unfortunately, excessive disclosures can also increase the cost of acquiring information, and in that case, disclosures will have the opposite effect—consumers will use less information to make their decisions.

In the view of the Taskforce, disclosures that provide additional information must seek to reduce the costs to consumers of locating the product or service they want. Disclosures should be focused on standardizing terms and facilitating comparability because these approaches can potentially reduce the costs of obtaining information. Disclosures should be tightly focused on information that is important to consumers and directly relevant to their purchasing decisions to avoid the problem of information overload. Disclosing all possible details and contingencies may appear to *provide* more information, but as discussed above, consumers may actually *use* less information.

The most appropriate use of disclosures is to correct problems in the market for information. The threshold inquiry should be to identify the specific problem that impairs the provision of important information. Information is often not provided because most consumers are not interested in the information, but disclosures will not correct that lack of interest—consumers will simply be uninterested in the disclosures. If, on the other hand, comparing competing offerings is difficult because different providers use different terms or calculate key parameters in different ways, a standardized definition can reduce the costs of information and facilitate informed choice.

A more problematic use of disclosures is what some have called "normative disclosures." These disclosures provide information not because consumers are interested, but because the policymaker thinks that consumers *should* take it into account.[116] These disclosures use information but as a means to nudge consumers toward a behavior that is thought more desirable than their actual behavior. Disclosures attempting to reduce the cost of acquiring

[116] Todd J. Zywicki, *Market-Reinforcing versus Market-Replacing Consumer Finance Regulation*, in HESTER PEIRCE AND BENJAMIN KLUTSEY, EDS., REFRAMING FINANCIAL REGULATION: ENHANCING STABILITY AND PROTECTING CONSUMERS, 237 (2016). See also Tom Durkin, *Requirements and Prospects f0r a New Time to Payoff Disclosure for Open-End Credit Under Truth in Lending,* FEDERAL RESERVE BOARD, FINANCE AND ECONOMICS DISCUSSION SERIES, (2006).

information respect consumers' preferences and provide them with the information they need to accomplish their goals. Normative disclosures seek to change their goals.[117]

One clear example is the required minimum-payment warning on credit card statements, which indicates how long it will take to pay off the outstanding balance by making only the minimum payment, and in many cases the payment required to pay off the balance in three years. The statement is more aimed at nudging consumers to pay more than the minimum payment than at providing useful information. The information is only of use to consumers who contemplate paying only the minimum indefinitely, and who plan to stop using the card in the meantime. By one estimate, that amounts to only 4 percent of consumers.[118]

The drawback of normative disclosures is that they contribute just as much to information overload as any other disclosure. Even worse, there is no clear limiting principle about which behaviors policymakers should try to influence, leading to the potential for significant increases in the information load confronting consumers. Attempting to nudge consumers in a "desired" direction therefore undermines the effectiveness of disclosures that actually seek to reduce information costs and may result in consumers making worse choices with less information.

7.6.2 Disclosure Requirements for the Information Age

We increasingly live in a world in which information is available on demand—not by reading through a lengthy document, but rather by more focused inquiries about particular product features or particular terms of an offer. Policymakers should rethink disclosure requirements, and how they apply in this environment. Rethinking should take into account that the appropriate goal for disclosures is to reduce the costs to consumers of locating the products and services they prefer.

We suggest that the focus for regulation of online information should be availability, rather than disclosure. Information about any term of the transaction or feature of the product should be readily *available*, but choosing which terms to consider should be up to the consumer. By "available," we mean that a website would provide, in a prominent location, links to any offer details that may be of interest to a particular consumer that is no more than two clicks away. Certainly, providers could highlight key terms of the transaction at the point of the link, and if

[117] Normative disclosures and "nudges" are distinct from financial literacy education efforts. Education seeks to teach consumers how to make better decisions by better understanding financial decisions and their consequences. A nudge seeks to push consumers to a favored conclusion.

[118] Zywicki, *supra* note 116.

there is clear evidence that most consumers want a particular item of information (e.g., the APR or the contract interest rate), it may be appropriate to require that information be provided at the point of the initial link.

As noted above, consumers ultimately decide which terms they attend to in any event, but "linear" disclosures mean that terms of little interest to the consumer interfere with their ability to locate the information they want. Scrolling through a required disclosure that provides all needed information is more likely to encourage consumers to scroll quickly to the bottom and click "accept" than it is to encourage careful consideration of the information provided. That is certainly what happens with the "terms and conditions" of online services and offerings. Online disclosures, however, need not be linear: Separate links that allow consumers to obtain more information about any term of interest can facilitate the information acquisition process. Such an approach would also generate data regarding what information is of most interest to consumers; most consumers will choose not to pursue all the details.

Information availability should facilitate competition to better inform consumers. Many, perhaps most, innovations in providing information at the time it is needed are likely to result from market competition, as sellers seek to provide consumers with the information they want when they want it. The information aggregators discussed above are a clear example. The proliferation of offers of timely information such as low-balance alerts or alerts about potentially erroneous transactions are driven by competition among financial service providers. So are apps such as Capital One's widely advertised Eno, which offers alerts about possibly mistaken credit card transactions, or apps that search credit card statements for recurring charges that a consumer may have forgotten.

"Just in time" disclosure, providing information at the point at which it is needed, is a promising approach to providing information, as the private-market examples make clear. Establishing such systems by regulation, however, seems exceedingly difficult. In the case of unexpected credit card transactions, for example, most consumers likely do not want an alert about each and every transaction on their card, especially if the account has multiple users. The constant flow of alerts would defeat the purpose of flagging potentially problematic transactions because it would effectively flag nothing. Market-driven service providers have the right incentives to limit alerts to transactions that are most likely to be of interest to the consumer, and to allow consumer choice of the level of alerts to the extent possible. Market incentives are not always perfect, but they are likely better, and certainly more responsive to changing circumstances, than a regulator's attempt to discern which facts must be provided. What current disclosure requirements make clear is that, to date, the regulatory incentive has been to disclose everything because it might be important to someone in some circumstances. That instinct is simply incompatible with "just in time" disclosure.

We recognize that some consumers need an alternative to online access to information, but that population is likely to be a significantly decreasing fraction of the population. A backup, paper-based alternative for some is likely to remain necessary for some time. Both because consumers are familiar with the existing system and because change is costly for those who must comply, these alternatives should change as little as possible from the present disclosure system. It is, however, far past time to rethink disclosures in the information age, which opens up a whole new range of possibilities.

8. Competition and financial consumer protection

In the United States, consumers acquire goods and services in markets. Most familiar are retail markets, where consumers shop for the necessities and comforts of life, from groceries and garments to housing and health care. Less visible are intermediate markets through which the streams of commerce flow as natural resources and human talent are transformed into finished products and services. Every exchange along the way holds the potential to add a cost to that commerce. The availability and affordability of everything that consumers buy depends not just on the expense of making and improving it, but also on the efficiency and effective regulation of every market through which it passes.

Efficient markets need not look alike. Exchanges as different as weekend farmers' markets, multilevel shopping malls, and worldwide electronic exchanges can all be effective means of matching buyers and sellers. Indeed, the variety of shapes, sizes, and dynamics that markets assume reflects adaptability to the preferences of their participants, another indicator of efficiency. For all the differences, however, efficient markets do have two characteristics in common: In every efficient market, one can expect to find competition and credit. In the field of economics, that expectation is part of the Efficient Market Hypothesis (EMH).

EMH posits that markets work best for buyers when they can choose among competing sellers. The same holds true for sellers seeking buyers. A market does not work for a trader who cannot find anyone willing to transact business at any price. Not much better is the market where buyers find just one vendor or sellers encounter only a single customer. A market cannot even begin to work for people who have value to exchange but are excluded from participating. Marginalized groups gain nothing from markets that are not open to them. These situations are examples of market failures. It is when a market attracts buyers and sellers in sufficient numbers to compete for the patronage of one another, and is open to all who are willing and able to trade, that it is most likely to reward them with fair value in exchange for what they bring to trade.

For consumers, access to fair and high-quality credit is the key to the marketplace. Consumers rarely come prepared to barter goods or services in exchange for something they want to buy.

Instead, they come with financial instruments that merchants will accept. Those instruments are a form of credit. Without personal credit or currency (the credit of a separate trusted source) that vendors will accept, consumers cannot obtain the goods and services that the most efficient and competitive markets might offer.

Financial services—the means by which people spend, save, and borrow—reach consumers through markets as well, and the same factors of efficiency and failure apply. A financial market is not working if people who can afford financial instruments cannot acquire them, because the market is closed to them or has failed - for example, when minority borrowers struggle to access credit for which they are qualified. Nor is it working when providers of financial services can escape the discipline of competition and charge premiums for the services that are available. Expensive, ineffective, or discriminatory financial instruments exact a toll on every transaction in which they are involved.

Consumer protection can enhance the performance of markets and the quality of the goods and services exchanged in them. Deception, abuse, and discrimination are antithetical to efficient markets, which rely on voluntary and informed exchange to produce the best outcomes. Law enforcement that suppresses misappropriation, extortion, discrimination, and other acts of malfeasance therefore improves market performance. It is the goal of consumer protection to prevent this behavior, and to remedy the injuries that occur when such practices occur.

Consumer protection can also reduce the impediments to market performance that stem from mistakes and confusion. Because uncertainties and misunderstandings can accompany transactions, especially those that span months or years, a well-functioning market relies on rules and procedures that deal with consumer understanding, unanticipated mistakes, economic distress, and contractual breaches in an efficient manner. Such rules and procedures make up an important component of effective consumer protection.

With potential hazards coming in many forms from many sources, no single measure can protect consumers from them all. Likewise, no single solution can remedy every injury that consumers may suffer. Accordingly, a robust regime of consumer protection deploys a combination of approaches and measures. The Dodd-Frank Act gave the Consumer Financial Protection Bureau (CFPB) a full complement of consumer protection tools, and these are described in other chapters. This chapter concerns a tool that is often overlooked in discussions of consumer protection and the Bureau's powers – the preservation of competition.

Before the Dodd-Frank Act laid out the powers of the Bureau, the statute described the purpose of the agency and objectives that Congress intended it to pursue. A single sentence stated the purpose:

The Bureau shall seek to implement and, where applicable, 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.[1]

Elaborating on that purpose is a set of objectives, each of which, implicitly or explicitly, gives a role to competition:

The Bureau is authorized to exercise its authorities under federal consumer financial law for the purposes of ensuring that, with respect to consumer financial products and services—

1. consumers are provided with timely and understandable information to make responsible decisions about financial transactions;

2. consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination;

3. outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens;

4. federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and

5. markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.[2]

These objectives rest on the proposition made explicit in the purpose of the Bureau—that competition is a principle component of consumer protection along with fairness and transparency. The first objective is to ensure the flow of information that enables consumers to choose wisely among competing alternatives. The second objective is to use the Bureau's regulatory powers to protect consumers from unfair, deceptive or abusive acts and practices, to protect consumers from discrimination, and to provide fair, equitable, and non-discriminatory access to credit for consumers and communities. The third objective, reducing unwarranted regulatory burdens, removes unnecessary costs, which can impede competition from smaller companies and raise prices beyond consumers' reach. With respect to the fourth objective, the congressional call for enforcement that gives no advantage to any sector could not be a clearer

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[1] 2 U.S. Code § 5511 (a).

[2] 12 U.S.C. § 5511(b).

mandate for fair competition among financial service providers. As for the fifth, the goal of preserving markets that facilitate access and innovation refers to the most recognized aspects of effective competition—welcoming customers, lowering costs, and improving products. This objective also highlights one of the most dynamic aspects of competition in the financial sector. Major advances in the history of consumer finance have been marked by innovations that made credit more convenient, more accessible, and less expensive.

In emphasizing the importance of competition to the mission of financial consumer protection, Congress drew upon a consensus that has enlightened trade regulation for centuries. The consensus includes a large body of academic research conducted in the 1970s, a century of federal economic policy, and a report drafted by a commission that Congress created 50 years ago, the National Commission on Consumer Finance (NCCF)[3]. After two years of research into many facets of consumer finance, the NCCF reported in its introductory letter that "a truly competitive consumer credit market, with adequate disclosure of relevant facts to an informed consuming public, together with legislation and regulation to eliminate excesses, will foster economic growth and serve to optimize benefits to the consumer."[4] These benefits need not come at the expense of consumer protections. To the contrary, explained the NCCF, "painful as competition may be for the participants, it provides the ultimate protection for most consumers."[5] In the consumer credit marketplace, with the information mandated by the Truth in Lending Act, NCCF favored competition as the "best means to assure that most consumers pay a fair price for their credit services." Competition under current law was ineffective in some areas, the NCCF concluded, particularly in addressing the problems of low-income consumers living in low income areas. That required special attention.

"Accordingly, the Commission urges as its first choice the adoption of state laws designed both to assure fair treatment of all consumers and to give all credit grantors equal opportunity to compete. Failing this, the Commission's second choice is to urge Federal legislation to accomplish this goal."[6]

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[3] 220.15.4 Records of the National Commission on Consumer Finance (History: Authorized by the Consumer Credit Protection Act (82 Stat. 164), May 29, 1968, to evaluate the consumer finance industry, in particular consumer credit arrangements. Activated by Presidential announcement, November 7, 1969, with first meeting held December 11, 1969. Chaired by law professor Robert Braucher, November 7, 969-January 21, 1971; and attorney Ira M. Millstein, January 22, 1971-December 31, 1972. Terminated upon submission of final report, December 31, 1972, published as Consumer Credit in the United States.) *See* https://www.archives.gov/research/guide-fed-records/groups/220.html.

[4] Ira M. lMilstein, Letter to the President and Congress, December 31, 1972.

[5] Report of The National Commission on Consumer Finance, Consumer Credit in the United States, 214 (Dec. 1972).

[6] *Id.* at 4.

Likewise, the NCCF envisioned an important role for antitrust enforcement, which should be "particularly alert to the dominance of consumer credit markets by a few firms, by barriers to entry, and to restrictive arrangements in the credit industry."[7] Antitrust enforcement could not be expected, however, to remove competitive impediments that were anchored in regulation that insulated them from challenge. The NCCF therefore advocated the repeal of laws that fixed rates or restricted services that consumers could access in competitive markets, and it urged the removal of legal barriers segregated financial institutions into sectors and prevented lenders in one from serving borrowers in another.[8]

That competition is critical to consumer protection was neither novel nor controversial when the NCCF espoused the idea in 1972. The best-selling economic textbook of the time (indeed of all time) was teaching the same lesson to college students and demonstrating how that lesson applied to credit markets.[9] Professor Paul Samuelson, who had won the Nobel Prize in Economics in 1970, explained in his text that year how competition can empower borrowers to obtain credit "at the cheapest possible terms" just as it allows shoppers to get the best prices from butchers.[10] He had made the same point to the Massachusetts legislature in 1969, when he testified on the proposed Uniform Consumer Credit Code:

A great deal of practical experience has accumulated among our various states and from careful comparisons across countries, to show that the consumer is most improved by effective...competition so that a range of alternatives are open to each consumer and so that each lender knows that his monopoly power to exploit the needy borrower is severely limited by these alternative opportunities. The same principles have been found to prevail in the market for small-loan finance as in the markets for the necessities of life.[11]

Like the NCCF, Samuelson did not expect competition to address all the problems of consumers and society. Acknowledging areas where pure free market competition might be less effective, in

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7 Id. at 3

8 Id.

9 PAUL SAMUELSON, ECONOMICS, 8th Ed. 578-79 (1970). The remarkable popularity of the textbook is reported in Elzinga, Kenneth G., *The Eleven Principles of Economics*, SOUTHERN ECONOMIC JOURNAL, 58:4, 861–79 (1992).

10 Id., at 579.

11 Statements of Former Senator Paul Douglas and Professor Paul Samuelson on the Uniform Consumer Credit Code to the National Conference of Commissioners of Uniform State Laws, January 29, p. 8 (1969).

his eighth edition of this textbook, he added two additional chapters: 1) “Economic Inequality: Poverty, Affluence, and the Quality of Life” and 2) “Economic problems of Race and the Cities.”[12]

Samuelson was far from the first economist to recognize the importance of competition, its role in protecting consumers, and its application to finance. Similar observations can be found in the work of Adam Smith, often regarded as the original economist.[13] In a treatise he published in 1776, “The Wealth of Nations”, Smith observed that the market, like an “invisible hand,” would direct sellers’ self-interest to the service of buyers.[14] His prediction came with a critical caveat, however: The market had to be competitive for buyers to benefit from the invisible hand. Smith concluded that the best incentive to keep a seller honest and fair was the fear of losing customers to a competitor. That was the “real and effectual discipline” that “restrains his fraud and corrects his negligence."[15] And to Smith there was no question whether the principle applied to financial firms. Competition among banks, he said, “obliges all bankers to be more liberal in their dealings with their customers, lest their rivals should carry them away. In general, if any branch of trade, or any division of labor, be advantageous to the public, the freer and more general the competition, it will always be more so.”[16]

By 1972, a consensus had formed among economists as to the circumstances that advance competition and the conditions that impede it. The NCCF drew upon this consensus and applied the analytical framework to the observations and data from the history of credit markets. For the most part, the conditions that qualified as catalysts of competition and contributors to consumer welfare remain recognized as factors that contribute today.[17] By the same token, the obstacles identified as impediments to competition and costs to consumers have been found again and again to impair markets across the economy. Those circumstances and their effects—both favorable and unfavorable—will be the focus of this chapter.

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[12] Israel Shenker, *Book Review of ‘Economics,’ Samuelson*, 8th ed., New York Times, Feb. 5, 1970.

[13] See SAMUELSON (1970), *supra* note 9, at 1. The coincidence of Smith’s publication with another notable event in 1776, the Declaration of Independence, was not by chance, said Samuelson: “[P]olitical freedom from the tyranny of monarchy was closely related to the emancipation of free-market pricing from the interfering hand of state regulation.”

[14] ADAM SMITH, WEALTH OF NATIONS, 14 (1776). Smith also recalled the butcher in explaining the working of a free market. In one of the most famous passages from the treatise, he wrote, “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.”

[15] Id., at 129.

[16] Id., at 313 (Smith also explained how competition encouraged prudence, and in a premonition of modern concerns about institutions too big to fail, hypothesized how competition could diminish the risk of financial system failures.)

[17] See, e.g. American Bar Association, *Antitrust Law Developments, 8th ed.* (2017) (surveying literature and cases).

Nothing in the fundamentals of financial markets suggests they would suffer from a lack of competition. The principal resources—financial and human capital, communication and information technology—are readily available and highly mobile. Financial intermediaries need offices, of course, but not the massive mines and factories of heavy industry to extract raw materials and process them into finished goods. Transportation costs are miniscule for both the inputs that the institutions acquire and the outputs they deliver; funds of any amount can move cheaply and easily to most of the population.

To be sure, financial intermediation—from the acquisition of capital to the delivery of services—requires efficient organizations, talented personnel, and sophisticated business models. Institutions with expertise and scale are more likely to succeed in obtaining capital at low costs and offering financial services on attractive terms.[18] Some services require national and global networks to be feasible and desirable, and some regions present challenges for the delivery of services. Above all, a reputation for integrity and reliability is a critical credential in financial affairs, and a history of honorable behavior confers credibility. Successful incumbents are likely to have such advantages over newcomers.

But incumbents with advantages over newcomers are neither unique to financial services nor incompatible with competition. Companies can multiply and industries can grow even when economies of scale and venerable reputations give advantages to familiar firms. Nowhere has this been more evident than with consumer credit, which has seen new entrants, innovative products, aggregate growth, reinvention of incumbents, and decline or departure of companies that could not keep pace with the others. These are the hallmarks of competitive markets.

Notwithstanding propitious conditions and encouraging indications of competition in credit, the NCCF identified numerous problems that prevented financial markets from performing as effectively as a competitive market would be expected to do. As described below, the impediments included various forms of restrictive licensing, limitations on services that companies could provide, geographical and sectorial barriers between institutions, and other conditions that made credit needlessly expensive to some and entirely unavailable to others. Some of the impediments were imbedded in regulation and legislation; others stemmed from perceived anticompetitive behavior in the industry.

These concerns warrant reexamination. If such conditions persist today, they could be thwarting or diminishing the forces that would otherwise have given consumers the benefits of better

[18] A study performed for the Commission noted relatively modest scale economies for loan offices. CR 286, n.3. See Chapter 4 of this report for a discussion of economies of scale in finance.

rates, greater access, and more services that robust competition can deliver. This chapter first reviews the NCCF's findings and recommendations on the state of competition in consumer finance and considers some of the costs that competition could have averted. Next, the chapter describes the evolution of credit markets since the NCCF's report and assesses trends that help explain the competitive circumstances consumers face today in credit markets. In the course of the discussion, the chapter identifies measures that could improve the quality, quantity, and affordability of financial services available to consumers.

8.1 Credit and Competition in the Post-World War II Economy

The end of World War II and the revival of the consumer economy marked the period that occupies most of NCCF's analysis of credit and competition. For the terms of that analysis, the NCCF resorted to a familiar definition: "When the number of sellers is so large and entry is so easy that no seller has power over price," competition could be expected, but not guaranteed, to make credit affordable and available.[19] A competitive market could be expected to lower prices to the lowest level consistent with covering production costs and profitability just sufficient to bring capital into the industry. Credit availability was measured by "the degree to which creditors are willing to provide credit at the free-market rate in a world without imperfections."[20] In other words, the NCCF viewed competition to have the most potential to offer the lowest rates for consumers and achieve the greatest access to credit in a perfect world. The Report then assessed the state of that competition and whether it was delivering the expected results.

The NCCF found varying degrees of competition in consumer finance markets in the early 1970s. Interest rates appeared to respond to supply and demand, and consumers seeking credit generally could obtain it at market rates. But the NCCF also found differences in access and

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[19] Id. at 109.

[20] Id. at 112-13 (In an ideally competitive market, rates reach competitive equilibrium levels through a series of adjustments by suppliers of various credit offers to various risk classes of consumers.' These rates are high enough to cover costs and enable creditors to earn a normal return on invested capital. Creditors are willing to extend any

amount of credit to qualified borrowers at such rates, and the situation can be characterized as one of full

availability.)

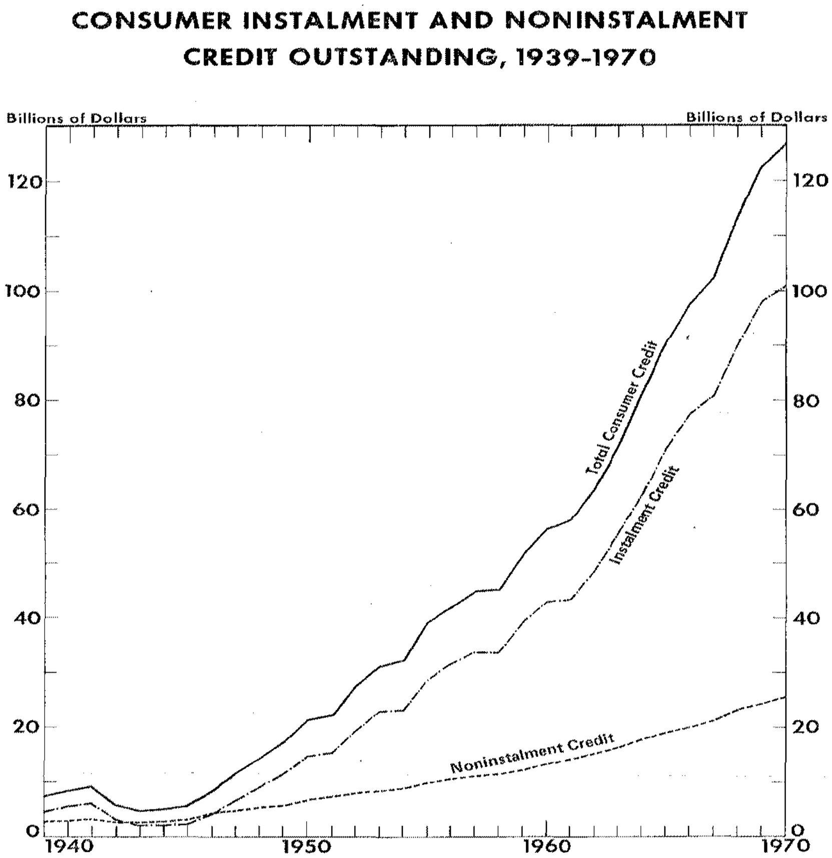
variations in rates across states and sectors. Depending on where consumers lived or borrowed, some paid higher rates and borrowed less, while others enjoyed lower rates and borrowed more—disparities that could not all be attributed to capital costs other fundamentals. Moreover, when credit was expensive and rare, it often coincided with indications of competitive shortcomings.

8.1.1 National Trends

In a national overview of consumer credit, the NCCF focused on different sectors of financial service providers. Some sectors had consolidated, some had disaggregated, and others had seen cycles of both. Overshadowing all the sectoral analysis was the dramatic growth in sources of consumer finance. A chart in the Report displayed the trends in consumer credit broken down by repayment methods, either installment or noninstallment, the latter including single payment loans, nonrevolving credit, money owed to service providers, and similar debts, and the growth took a dramatic upward turn in 1945, as did the US economy that grew at its fastest sustained pace in a century between 1950 and 1973:[21]

[21] C.I. Jones Stanford GSB, *The Facts of Economic Growth,* in HANDBOOK OF MACROECONOMICS, Volume 2A Exhibit 2 -1, at 9 (2016), available at http://dx.doi.org/10.1016/bs.hesmac.2016.03.002, NBER, available at http://web.stanford.edu/~chadj/facts.pdf.

FIGURE 8-1: CONSUMER INSTALMENT AND NONINSTALMENT CREDIT OUTSTANDING, 1939-1970



Among the factors fueling this growth were tens of thousands of potential competitors in the business of making loans to a population that was booming, urbanizing, and challenging the customs and restrictions that society had long imposed. Some 13,600 commercial banks held more than $50 billion in consumer credit in 1970, more than any other segment and about 40 percent of the total outstanding in the United States.[22] Finance companies—about 3,700 in 1965, operating out of an estimated 13,000 to 14,000 offices—accounted for the second largest

[22] Id. at 8.

portion, with 30 percent of the consumer credit outstanding. Outnumbering both banks and finance companies were 23,650 credit unions, although their share of credit outstanding came in lower, at 12 percent in 1970. Probably more numerous than any other sources were retailers, who held about 14 percent of consumer credit outstanding as the 1960s ended, but a precise tally of their number was not available.[23] Outside these main categories, other lenders (such as savings and loan associations and mutual savings banks) amounted to about 1.5 percent of the credit outstanding.[24]

Dollar volumes of the holdings of these sectors reflected the dramatic growth of installment credit outstanding—from under $15 billion to more than $100 billion—over the two decades ending in 1970.[25] Banks and finance companies each held more than twice as much as all the institutions combined just 20 years earlier. Credit unions and retailers each held almost as much as the entire amount outstanding in 1950.

FIGURE 8-2: EXHIBIT 2-4 OF THE COMMISSION'S REPORT SHOWED THE VOLUMES AND SHARES OF INSTALLMENT DEBT[26] BY INSTITUTIONAL SECTORS IN 1950 AND 1970.

	Amounts outstanding (Dollar amounts in millions)			
	December, 1950		December, 1970	
	Amount	*Percent*	*Amount*	*Percent*
Commercial banks	$5,798	39.4	$41,895	41.4
Finance companies	5,315	36.1	31,123	30.8
Credit unions	590	4.0	12,500	12.4
Miscellaneous[a]	102	0.7	1,546	1.5
Retail outlets	2,898	19.7	14,097	13.9
Totals	$14,703	100.0	$101,161	100.0

[a]Miscellaneous lenders include savings and loan associations and mutual savings banks.
Details may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

Aggregate growth bodes well for competition, as it is easier for new companies to enter and small rivals to thrive in a market that is expanding. Customers in a market for the first time are

[23] Id. at 11

[24] Id.

[25] See Table 2-1 in CICO Chapter 2 for a longer series.

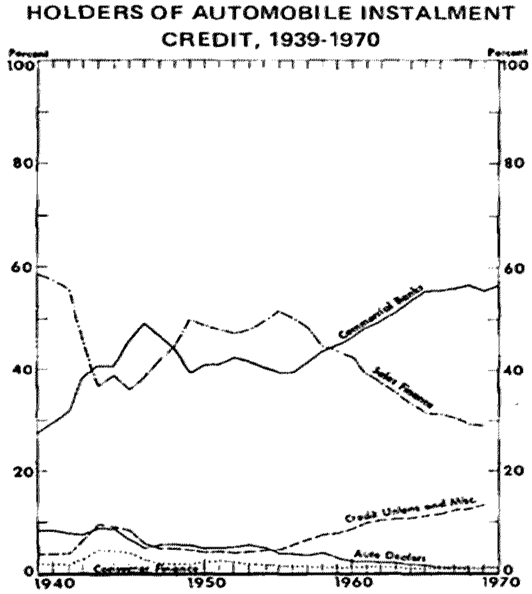
[26] NCCF, *supra* note 5, at 11.

less likely to have developed loyalty to an established firm. And entry itself can accelerate the expansion of a market, as new companies and smaller rivals hustle to establish themselves and grow their businesses.

One indicator of competition is the volatility of market shares of the sellers in a market, as credit unions, finance companies, commercial banks, and Morris Plan Banks had demonstrated before the war. Changing shares can reflect rivalry among firms already within a market, entry of new firms into the market, and innovation that disrupts historic patterns. When established firms charge more than necessary to cover the costs of providing the goods and services they sell, the resulting profits invite entry by others. Inferior quality, untapped innovation, and poor service are other signals that alert existing and potential competitors to the prospect of rewards for anyone who can improve upon the status quo. New entrants and opportunistic rivals empower consumers to discipline companies who do not perform. Such discipline can manifest itself in the movement of consumers from one seller to another, in the movement of companies to into and out of a market, and in the revitalization of underperforming incumbents. In markets where consumers can shift their allegiance, market power is unlikely to persist for long, if it arises at all.

The NCCF tracked shares of the institutional sectors that held consumer credit in the decades ending in 1970. At first glance, shares appeared relatively stable. Banks, with 31 percent in of installment credit in 1970, had added two percentage points to their 1950 share of 29 percent. Finance companies and retailers lost about five and six points from their 1950 shares of 36 percent and 20 percent, respectively, while credit unions added eight points, impressive growth on a percentage basis given the 4 percent that the sector held at the beginning of the period. Still, credit unions remained in fourth place among the four main categories of consumer lenders nationally.

FIGURE 8-3: HOLDERS OF AUTOMOBILE INSTALMENT CREDIT, 1939-1970

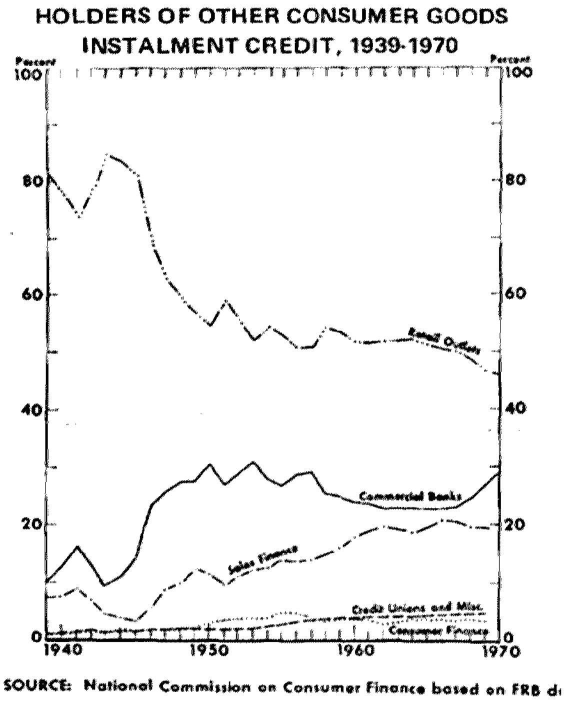


The picture changes dramatically when these sectors are examined more closely. In loans for automobiles, home appliances, and home improvement—rapidly growing industries in the post-war economy—institutions gained and lost shares to an extent that belied the seeming stability of their positions at the beginning and end of the period. For example, sales finance companies (many affiliated with the automobile industry) dominated lending for vehicles in 1940, with nearly 60 percent of the credit outstanding, twice the share of commercial banks.[27] The lead did not last long. In just a few years, banks bypassed finance companies and were making about half the overall lending for autos in the late 1940s. Finance companies recovered just as quickly, overtaking banks and maintaining the lead source of auto loans for most of the 1950s. But as the 1960s loomed, banks once again had resumed their growth, finishing the decade with almost twice the share of their chief rivals. By 1970, in a much larger market, banks held nearly 60 percent of the auto installment credit, twice as much as the finance companies. It was also in the late 1950s and 1960s that credit unions grew steadily. More than 30 percent of their loans in 1971, amounting to more than $3 billion, financed auto purchases.[28] Meanwhile, the small share attributable to auto dealers nearly disappeared.

[27] NCCF (1972), *supra* note 5, Exhibit 2-5 of the Commission's report illustrated these shifts.

[28] NCCF (1972), *supra* note 5, at 12

FIGURE 8-4: HOLDERS OF OTHER CONSUMER GOODS INSTALMENT CREDIT, 1939-1970



In the market where consumers sought to finance purchases of expensive appliances, furniture and other items at retail stores, the retailers who sold the goods began the period with a seemingly commanding lead over the other sources of credit, only to take a precipitous fall. In the early 1940s, retailers held more than 80 percent of installment credit in this category. By 1970, their share had dropped below 50 percent. Commercial banks and sales finance companies more than doubled their shares over the same period, reaching about 25 percent and 20 percent, respectively.[29].

[29] Id.

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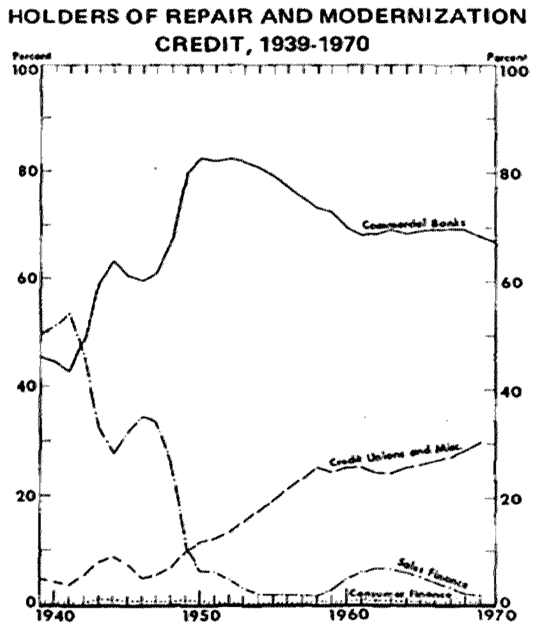
FIGURE 8-5: HOLDERS OF REPAIR AND MODERNIZATION CREDIT, 1939-1970



In one category of credit the segment leader virtually disappeared. Sales finance companies held half the outstanding credit for modernization and repair in the early 1940s. Banks were a close second, with credit unions far behind. By 1970, sales finance companies' share was approaching zero. Banks and credit unions each had added 25 points to their 1940 shares and finished the period with nearly all the loans for these home improvement projects. Credit unions grew sixfold, from about 5 percent to 30 percent.[30]

With different types of institutions vying for the same types of loans, and certain sectors taking substantial shares from other sectors, competition was obviously crossing institutional lines. Inside the sectors, the forces that the firms faced were likely more turbulent still. New entrants would have posed constant threats to established institutions. According to the National Credit Union Association, federal credit unions numbered nearly 6,000 in 1952.[31] The NCCF tallied more than 23,000 (likely state and federal) in 1972.[32] Between 1950 and 1970, banks added about 20,000 branches. Bank credit cards were growing even more rapidly by 1970. At the end

[30] Id.

[31] *See, Historical Timeline,* NATIONAL CREDIT UNION ASSOCIATION, available at https://www.ncua.gov/about-ncua/historical-timeline. Those entrants either brought new customers to consumer finance or took business from other credit unions or financial institutions. Most likely the newcomers did both.

[32] NCCF (1972), *supra* note 5, at 8.

of 1967, 390 banks reported some $800 million in credit-card debt outstanding.[33] Three years later, more than 1,200 banks, still a minority, reported $3.8 billion. Consumers were flocking to new products, new companies, and new offices. Incumbents could not afford to be complacent if they wanted to keep account holders from taking their business elsewhere.

Given the rapid expansion of credit over this period, shrinking shares still may have signified growth, albeit slower, but some sectors declined absolutely despite the expansion. Consumers, in numbers large enough to double or decimate sectors in the course of a decade or two, were rewarding companies that offered attractive terms and penalizing those that compared poorly. Later, this chapter describes how the ongoing rivalry among existing lenders and the entry of new sources of consumer credit continued to produce dramatic changes in the nature and structure of the sector since the NCCF's Report.

8.1.2 Differences Among Institutions and States

If national numerosity alone determined competition, then the thousands of credit sources and their churning market shares might indicate that the balance of power in these markets favored consumers, not lenders. But national trends do not reflect the conditions an individual borrower might face. The markets for most consumer financial services were local or regional in the decades the NCCF studied. Retailers offering attractive charge accounts in Pittsburg or banks with low interest rates in Philadelphia were unlikely to help consumers in Chicago.[34] By the same token, consumers shopping for cars anywhere would have found credit cards and home improvement loans to be poor substitutes for auto loans. To be sure, a customer might have been able to buy an appliance or roof repair on credit in order to set aside cash for a car, but such substitution is less convenient than choosing among competing auto lenders. For reasons such as these, nationwide tallies of financial providers, aggregate shares of debt outstanding, and other structural characteristics may not reveal the vigor of competition or the alternatives available when customers are looking for credit.

The NCCF, recognizing that the relevant competition occurred in geographic markets smaller than the entire United States and in product markets narrower than all consumer credit, focused on differences among cities and states, and within sectors, in its analysis of concentration and

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33 Id. at 12.

34 Even commercial customers tended to bank locally, as the Supreme Court observed in an antitrust case that had found New York to be in a different banking market from Philadelphia in 1963. United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963)

performance.[35] Geography was typically broken down by states. Lines of business were defined by categories of credit—including automobile loans, retail installment credit, and installment credit for other consumer goods —and comparisons of access and rates in different states. For each category, the NCCF assessed quantitative and qualitative evidence bearing on competition. The quantitative factors included structural characteristics – primarily the numerosity and concentration of lenders. Among the qualitative factors were conditions allowing or impeding entry into credit markets, caps on interest rates, and business practices that could restrict competition. These circumstances were checked for potential effects on rates of interest and availability of loans.

8.1.3 Automobiles—

The NCCF's cross-sectional analysis of lending in different states found both evidence of competition and indications of market power. In automobile loans, for example, "quantities of credit extended vary inversely with market power" (measured by market concentration of banks).[36] Also evident was a predictable corollary of lower quantities: Where quantities fell, rates rose. The analysis revealed significant correlations between bank concentration and interest rates that car buyers paid across a broad spectrum of states. A comparison of states at the high and low ends of the spectrum exposed the potential costs of the disparities. Consumers who lived in states where banks were fewer (i.e. more concentrated) paid an average premium of about 70 basis points, and they paid this premium whether they borrowed from banks or borrowed from dealers who then sold the loans to the banks.[37]

The difference in interest rates coincided with larger differences in the behavior of borrowers. A significant segment of consumers paid another premium when they took out auto loans in concentrated states, because when banks made fewer loans, dealers filled the gap. In less concentrated states, banks were the leading source of loans, by a wide margin. Direct bank loans accounted for 42 percent of financed sales, nearly doubling the 24 percent of the sales financed by dealers (who then sold the loans to banks or finance companies). Where banks were more concentrated, the shares reversed; sales financed by dealers (and indirectly financed by banks) outnumbered sales directly financed by the banks themselves. Dealers extended 37 percent of bank-financed loans, while banks handled 23 percent directly. In other words, dealers' share of

[35] See, e.g. NCCF (1972*), supra* note 5, at 138.

[36] *Id* at 112 (In addition, in "all but a few states, rate ceilings are inconsequential as a determinant of the market rate.")

[37] *Id.* at 122.

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bank-backed financing grew by half, while direct bank lending dropped by almost the same proportion, in concentrated states. For consumers, the shift to dealer financing may have had a greater impact than the rise of bank rates in concentrated states, since dealers charged APRs about two points above banks' direct rates across all states.

The practical significance to consumers of 70 basis points and 2.7 percentage points can be illustrated by considering the effects of those premiums on total payments for a typical 1970 auto loan in today's dollars. An increase of 70 basis points—the direct-loan premium that the NCCF attributed to market power—would cost the consumer an extra $200 over three years in 2020 dollars for the median loan.[38] An additional 2.7 percentage points—the difference between rates paid by direct borrowers in competitive states and indirect borrowers in concentrated states—would generate extra interest payments of $900 in inflation-adjusted dollars over the life of a three-year loan.[39]

It is conceivable, of course, that the consumers who borrowed from dealers would not have qualified for average bank rates, and that some consumers probably preferred to pay for the convenience of borrowing at the dealer. But that does not explain such wide disparities in bank shares and dealer shares of credit extended across states. There is no reason to expect that borrowers seeking more convenience or presenting greater risk would cluster in the states where fewer banks charged higher rates.

The NCCF cautioned that other factors may have confounded the results.[40] For example, some of the low-concentration states had lower statutory rate ceilings, high-concentration states often allowed branch banking, and different costs may have explained some of the interest-rate variations. Thus, even though the reported correlations between concentration of banks and the borrowing patterns were statistically significant, the NCCF noted that concentration "does not inevitably result in anticompetitive behavior, nor does branch banking inevitably result in high concentration."[41]

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[38] The premium calculation assumes a loan of $3,000 in 1970 amortized over three years. Adjusted for inflation, $3,000 in 1970 is $20,000 in 2020. The median auto loan in 1971 was $3048, with a maturity of 34.5 months [NCCF at 15; CPI Inflation Calculator, https://www.in2013dollars.com/us/inflation/1970?amount=3000.]

[39] The calculation assumes a $3,000 loan amortized over three years in 1970.

[40] NCCF (1972*), supra* note 5, at 122-23.

[41] Id. at 123. (Developments described later in this chapter reveal that the Commission's concern about branch banking was misplaced.)

Second, the concentration levels the NCCF observed were relatively low, even in the states that fell into the highly concentrated category. In those states, the four largest banks on average accounted for 64 percent of the money lent to finance automobile purchases. Thus, more than a third of the loans were made by at least three other banks.[42] Academic research and antitrust enforcement generally agree.[43]

Third, as the NCCF observed, concentration alone does not confer market power, if smaller competitors and new entrants can take business away from established companies that charge monopoly prices. High prices are signals to current and future rivals that profits are available in a market. Dominant firms need rivals constrained and entry impeded if they are to succeed in reaping the rewards of market power. In some cases, they enjoyed those conditions, and still do. These are addressed after a review of the other forms of credit in the NCCF's Report.

Qualified conclusions about the correlations between concentration and competition were warranted. First, as the NCCF noted, correlation does not indicate causation. Second, statistical significance does not equate to explanatory power. And third, the quality of the data was questionable. Important measures that were not included could have confound the results, and aggregate data that was used could be a poor proxy for conditions in local market. A study published in 1975 tested the structure-performance hypothesis with more refined data, and it emphasized the qualifications as much as the conclusions. Focusing on local markets for installment loans, Beighley and McCall found statistically significant relationships between market power and various measures of concentration, but that the relationships were not "of a magnitude to be of great operational significance in determining a bank's market power."[44]

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42 For the remainder to be accounted by three banks, each would have had a 12 percent share. If they were not equal in size, and it is rare to find such parity, then the number of additional competitors had to be greater than three.

43 See, e.g. Thomas Kauper, *The "Warren Court" and the Antitrust Laws: Of Economics, Populism, and Cynicism*, MICHIGAN LAW REVIEW, Vol. 67, No. 2, pp. 325-342 (Dec., 1968); Orley Ashenfelter, Daniel Hosken and Matthew Weinberg, *Did Robert Bork Understate the Competitive Impact of Mergers? Evidence from Consummated Mergers*, THE JOURNAL OF LAW & ECONOMICS, Vol. 57, No. S3, (August 2014), pp. S67-S100.

44 Beighley and McCall, *Market Power and Structure and Commercial Bank Installment Lending*, JOURNAL OF MONEY, CREDIT, AND BANKING (1975).

(Market power was measured by the Lerner price-marginal cost index, and concentration was measured by inequalities among individual bank market shares, market shares of the leading bank groups, and numbers of commercial banks.)

8.1.4 Financing Retail Goods

For the category of other consumer goods (those mostly bought at retailers), the effect of rate restrictions made credit markets difficult for the NCCF to assess.[45] Interest rates varied little from state to state for revolving credit. Rates hovered around 18 percent, not necessarily because of competitive conditions, but due to common usury limits. The rate caps made it difficult to disentangle the effects of competition from the effects of rate ceilings. Where rate ceilings were high or nonexistent, competition kept rates below the ceilings, but where ceilings were relatively low, the NCCF detected excess demand for credit; consumers were unable to obtain loans at rates they would have been willing to pay. [46]

Convenience was an important factor for consumers when financing retail purchases. Credit granted at the point of purchase was more attractive than the option of going elsewhere for the funds to buy an expensive appliance or piece of furniture, and consumers took advantage of the opportunity. Banks and credit unions combined for less than 10 percent of such purchases.[47] Location was an obvious advantage for retailers, who did not face as much competition from other sources as, for example, auto dealers did.

Higher concentration among retailers was associated with fewer goods financed at stores, but retailer concentration varied relatively little from state to state—significantly less than in the banking sector. In the more concentrated category were states where four stores averaged two-thirds of sales, meaning more than two (likely many more, since they were smaller) made up the remainder. In less concentrated states, the top four retailers still exceeded half of all sales. Such variations in concentration did not signify competitive concerns to the NCCF. It recognized that the retail sector was highly competitive, given that it was a business easy to enter and exit, with a history that frequently displayed both.[48]

How much consumers actually paid for retail credit was difficult to measure, because interest rates were not the only means by which retailers could recover their costs. If an interest rate cap prevented a store from raising rates on charge accounts, it could raise the prices of the goods financed. The Report cited research showing that appliance prices in a market with low rate caps

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[45] NCCF, *supra* note 5 at 126.

[46] Id. at 124-25.

[47] NCCF (1972), *supra* note 5, at 126.

[48] NCCF (1972), *supra* note 5, at 106.

were about 5 percent higher than in nearby markets with high or no caps.[49] For customers, increased cash prices indicated that everyone might have been paying interest, whether they purchased with credit or cash. Consumers who paid in cash may have subsidized those who paid with credit.[50] The NCCF worried that such a subsidy would have amounted to a regressive transfer from poorer to wealthier consumers, since cash buyers would include those who could not qualify for charge accounts.[51]

8.1.5 Finance Companies and Other Sources

Finance companies confronted a wide variety of competitive conditions from state to state, and consumers' fortunes in the sector reflected those variations. Loans were more readily available from finance companies where economies were stronger, concentration was lower, and the companies enjoyed lower labor costs. As in retail revolving credit, competition kept rates below the legal caps in many markets, and credit was widely available in them. But again, the effects of competition on interest rates themselves were difficult to assess because usury limits in some markets often controlled rates that lenders could charge, and the volume of credit demanded at those rates exceeded the volume available. Perhaps for that reason, the correlations between concentration levels and rates were weak, and again the NCCF noted that confounding factors may have explained the associations.

8.1.6 Market Restrictions Across Sectors

Across all the sectors, the NCCF found disparities in consumers' access to affordable credit associated with restrictions that directly impaired competition. Where the NCCF found concentration, it often found barriers to entry and restrictions on credit practices. Restrictive Convenience and Advantage licensing, for example, was associated with reduced availability of loans and increased concentration of finance companies.[52] They were 50 percent more concentrated where entry was impeded, so the entry barriers could have explained the negative correlations between concentration and access. The NCCF recognized that concentration may have been a consequence, rather than a cause, of restrictions on competition, just as high

[49] NCCF (1972), *supra* note 5, at 106.

[50] Id. at 107.

[51] Id. ([T]he burden of subsidy falls primarily on cash buyers, some of whom may have been unable to obtain credit. Thus state laws that put the price of credit below competitive rates are forcing both the wealthy and the less affluent, who do not use or cannot obtain credit, to subsidize the use of credit by others.")

[52] Id. at 130-31.

interest rates and reduced availability of credit appeared to have been.[53] As the NCCF characterized the record:

There is ample evidence indicating that competition is impaired in a number of states by a variety of conditions affecting all of the major types of consumer credit. A common structural condition of these markets is that they tend to be highly concentrated and difficult for newcomers to enter because of relatively slow growth in demand for credit, or legal restrictions on entry, or some other impediment or combination thereof. By comparison many other state markets appear to be fairly competitive, a judgment which is indicated not only by the existence of contrasting structural conditions but also by related measures of better performance.[54]

Consumers suffered costly consequences in states that protected financial institutions from competition. Different ceilings for different lenders created market segments that allowed a few firms to dominate without fear of encroachment from other segments. For example, commercial banks in New York were confined to a maximum rate of 11.6 percent, which prevented their entry into "the $500 loan market served by consumer finance companies at 24.8 percent."[55] The NCCF noted that borrowers "would have been significantly better off if banks had always been able to charge the same rates permitted licensed lenders." The significance is apparent from a conversion of the principal and interest on the $500 loan into current dollars. Inflation since 1970 has turned the purchasing power of $500 into $3,400 today.[56] Expressed in 2020 dollars, the difference in interest rates (24.8 instead of 11.6) could have cost borrowers as much as an extra $260 in interest payments on a one-year loan.[57] The disparity would have been greater for loans of longer maturities and for borrowers who would have qualified for lower rates at the banks. It would have been less for borrowers who got better deals at finance companies and those who would not have qualified for the better bank rates.

Banks, for their part, enjoyed protection from finance companies. For example, reported the NCCF, "licensed lenders in New York may lend no more than $1,400 to any one borrower, whereas banks may make consumer loans as high as $5,000." Banks could make loans between

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53 See, e.g. Id. at 136.

54 Id. at 136

55 Id. at 238.

56 Inflation conversion from Saving.org, available at https://www.saving.org/inflation/.

57 At 24.8 percent, interest payments would have added up to $475 instead of $215 for the lower rate. A precise comparison would take into account the added expenses of administering smaller loans and poorer credit records of finance-company customers, but it is difficult to dismiss the conclusion that they paid a great deal for the restrictions placed on banks. Interest calculations from Saving.org, at https://www.saving.org/calculators/loan-calculator.

those amounts without worrying about competition from finance companies. The segmentation created by these restrictions that separated classes of credit grantors, the NCCF said, was "blatantly anticompetitive."[58]

The consumers who suffered the most serious may harm may not have been those who paid the higher rates. Where rate caps were low and entry restrictions high, lenders rationed loans and turned away applicants. By the NCCF's measure, in states with both types of restrictions, people took out fewer loans and smaller loans – about two-thirds as much overall—while rejection rates were almost half again as high as those in states with easier entry.[59] Applicants had little more than a 50-50 chance to get a loan in states that regulated rates and entry. The odds were 2:1 in consumers' favor in less restrictive states. Where entry was restricted but rate ceilings were relaxed, rejection rates for credit applicants still rose and the average size and number of loans still lagged, but not by as much. Adverse consequences of entry barriers thus occurred in states regardless of rate ceilings; only the extent of the damage differed.[60]

Regulations limiting entry and access were not, however, the only source of competitive impairment in the credit sector, the NCCF believed. It was concerned with private threats to competition as well. Accordingly, the Report called for vigorous antitrust enforcement against restraints of trade, and it identified practices that should be investigated:

Although almost obvious, the Commission recommends that antitrust policy, both federal and state, be alert to restrictive arrangements in the credit industry. Any hint of agreement among lenders as to rates, discounts, territorial allocations, and the like must be vigorously pursued and eliminated.[61]

The Antitrust Division of the Department of Justice and the Federal Trade Commission (FTC) have challenged and eliminated many agreements among competitors that could have restricted competition. But many such agreements are beyond their reach. Some of the "blatantly anticompetitive" restrictions that the NCCF identified are also the most enduring, because the antitrust are laws typically exempt from prosecution restraints that governments authorize. Against such restraints, advocacy for competition and consumers remains the primary approach for antitrust enforcers, and the combination of enforcement and advocacy has been effective at

[58] NCCF (1972*), supra* note 5, at 94.

[59] NCCF (1972*), supra* note 5, at 131.

[60] NCCF (1972*), supra* note 5, at 132.

[61] NCCF (1972*), supra* note 5, at 138

"eliminating anticompetitive barriers to competition…and providing consumers with the information they need to take advantage of a competitive marketplace."[62]

Restricted competition can be beneficial for financial institutions, the NCCF recognized, because market power meant stability and profitability of the insulated incumbents. Stability and profitability appealed to financial authorities as well, but the NCCF criticized regulators over "excessive concern…for the protection of the profitability of existing bank institutions" and disagreed that the restraints served the "needs and convenience" of the public."[63] In the judgment of the NCCF, allowing "domination by relatively few firms" of affected markets was not worth the costs.

The NCCF could have framed its conclusion more directly in terms of effects on consumers. When regulators allow the welfare of the banks to outweigh the interests of consumers, those who are supposed to benefit from oversight instead pay its costs.[64] For consumers who could get credit despite unfavorable conditions, the costs were higher rates and smaller loans. For consumers who could not, the costs came in the form of doing without the goods or services, or intergenerational accumulation of wealth that credit would have made available. The most desperate consumers, not infrequently consumers who faced discrimination in an unregulated market, found a third way: doing business with illegal lenders. It was well known in the decades the NCCF studied that "consumer lending was a standard business activity of criminal organizations operating in many major metropolitan areas across the United States."[65] Restricting legitimate competition sometimes simply sends it to the underworld, where consumer protection depends on the rules and remedies of juice loans and enforcers.

Numerous findings from the NCCF's assessment of competition bear on the potential for discriminatory practices by lenders. Already noted was the analysis of access in the Report, which found that restrictions on competition frequently reduced the availability of credit,

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[62] United States, THE INTERFACE BETWEEN COMPETITION AND CONSUMER POLICIES, Contribution to the Global Forum on Competition, OECD (2008) The Antitrust Division of the Justice Department and the Federal Trade Commission explained: "Because the "state action doctrine" in United States law protects state laws from antitrust challenge in most cases, the FTC and DOJ have focused their efforts on competition advocacy [arguing] that consumers are better protected when they can choose between high cost/high service and low cost/low service providers rather than requiring them to pay for services they may not want or need." Available at http://www.oecd.org/unitedstates/39915760.pdf.

[63] NCCF (1972*), supra* note 5, at 137.

[64] Id.

[65] Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd Zywicki, Consumer Credit and the American Economy 362 (2014).

leading to rationing that presumably excluded borrowers of lesser means and lower credit scores. In the data, the NCCF looked specifically for indications of gender discrimination and found widespread evidence of it.[66] The NCCF also conducted some research on racial discrimination but the evidence it collected was too limited to draw reliable conclusions.[67] Elsewhere this Report (see Chapter 10) considers more recent information on discrimination. Later this chapter considers competition and access in modern credit markets.

To improve competition the NCCF proposed a menu of policy changes that would expand consumers' choices and advocated regulations that could improve the wisdom of those choices.[68] To implement its recommendations, the NCCF recommended that legislators, regulators, and enforcers strive to design and implement a sound competition policy for consumer credit. The goals of that policy should be these:

Promoting and maintaining competition among numerous sources of credit. Competition is the key ingredient "of a finance industry capable of providing an adequate supply of credit at reasonable rates"

Assuring "access *by all* to these alternate sources"

Preventing "excesses which the 'system' may invoke against the borrower."[69]

Among all the available means to improve competition, the NCCF concluded that enhancing the ability of potential competitors to enter credit markets would be the most effective policy. In his communication to the President and Congress, the Commission Chairman explained:

As to our conclusion that free and fair competition is the ultimate and most effective protector of consumers, we have recommended the elimination of restrictive barriers to entry in consumer credit markets by permitting all creditors open access to all areas of consumer credit. We have urged the entry of savings and loan associations and mutual savings banks into the consumer credit market. We have recommended prohibitions on acquisitions that would eliminate potential competition or that would substantially increase concentration in state or local credit markets. We have also urged that rate ceilings which constrain the development of workably

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[66] NCCF (1972), *supra* note 5, at 160 (For a review of the role women played a prominent role in consumer credit markets from medieval times to the nineteenth century, see the Appendix.)

[67] NCCF (1972), *supra* note 5, at 153-55.

[68] NCCF (1972), *supra* note 5, at 214, See, e.g Ch. 10.

[69] NCCF (1972), *supra* note 5, at 2 (emphasis in original).

competitive markets be reviewed by those states seeking to increase credit availability at reasonable rates.[70]

Thus, the critical prescription for competition was to preserve the competitive dynamic that had characterized well-functioning credit markets in in the postwar period. The NCCF recognized that this recommendation would not address all problems in credit markets, including access by marginalized groups. Markets that were open to entry and free of constraints that prevented companies from challenging one another were perceived to be the most likely to remain competitive and protect consumers.

8.2 Competition in Credit, 1970 - 2020

The NCCF devoted a chapter of its Report to predictions on the future of consumer credit. Not surprisingly, many of those predictions failed to capture the nature and size of the markets in which credit is exchanged today. For example, the NCCF anticipated, "with a slowdown in the rate of increase in consumer credit and with fewer additions to the types of goods and services financed, credit grantors in the future are relatively more likely to rely on price competition than on nonprice competition."[71]

Fortunately for consumers, the future exceeded expectations. Price competition continued to reduce costs of credit, but the most remarkable developments in competition came from new products and services. Among the aspects of nonprice competition that the NCCF did not predict was the rise of automated teller machines (ATMs), although the first one had made its appearance in the US in 1969 (two years earlier in the UK).[72] Nor did the NCCF foresee banking by computers and smart phones, still far in the future. For virtually every consumer in 1970, withdrawing cash meant going to the bank, obtaining a loan meant visiting a lender, and getting competing quotes meant visiting several sources—advertising might help start a search but narrowing options on the internet was unheard of. The NCCF did predict the growing use of bank-issued credit cards and the value they would deliver to an increasingly mobile population. It did not fathom the extent of the growth, or the effect that growth would have on the

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70 NCCF (1972), *supra* note 5, at iii.

71 NCCF (1972), *supra* note 5, at 203

72 Linda Rodriguez McRobbie, The ATM is Dead. Long Live the ATM!, Smithsonian Magazine, January 8, 2015. https://www.smithsonianmag.com/history/atm-dead-long-live-atm-180953838/.

competition for consumer credit. Inconceivable at the time was a vast market for consumer finance that involved no visit to any location or meeting with any individual.

As for overall growth, the figures in Table 2-1 and 2-2 of Chapter 2 reveal that consumer credit outstanding has increased *thirtyfold* since the Commission's Report.[73] Most of that growth has come from financial services and technologies that were nonexistent or insignificant in 1970. And a good portion of that growth reflects more consumers participating, both absolutely and proportionately, in legal credit markets today than in 1972.

The structure of the consumer finance sector appears to have changed significantly in the 50 years since the NCCF's Report. At first glance, the traditional sources of credit show consolidation:

The number of FDIC-insured banks dropped from more than 13,000 to fewer than 5,000 in 2018.[74]

Federally Insured Credit Unions numbered about 5,200 in the final quarter of 2019[75] The Commission had tallied more than 23,000 in 1972.

Finance companies, which the Commission in 1972 estimated at 3,700, have no authoritative census today but may have doubled to around 7,800.[76]

Dollar volumes and shares of consumer credit from Table 2-1 in Chapter 2 of this Report allow for comparisons of the major sectors around the time of the NCCF's Report to those today. Table 8-1 highlights the institutional types then and now:

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[73] To be precise, the Commission predicted that the *rate* of the growth of credit would decline after 1970, and that turned out to be correct. The amount of credit outstanding was so small in 1940 that the $100 billion increase through 1970 represented a slightly higher annual rate than the $4 trillion increase since 1970.

[74] *Annual Historical Bank Data*, FDIC available at https://banks.data.fdic.gov/explore/historical?displayFields=STNAME%2CTOTAL%2CBRANCHES%2CNew_Char&selectedEndDate=2018&selectedReport=CBS&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc

[75] *NCUA Quarterly Reports*, available at https://www.ncua.gov/newsroom/press-release/2020/ncua-q1-2020-state-credit-union-data-report-now-available (In the eight years from December 2011 and December 2019, 1,800 credit unions exited the business.) CUNA estimated about 5,500 at the end of 2019, down from 11,000 in 1999. *See Monthly Credit Union Estimates*, June 2020. https://www.cuna.org/uploadedFiles/Global/About_Credit_Unions/CUMonthEst_Jun20.pdf.

[76] One investors' service reported 7,800, *see United States Finance Companies,* CRUNCHBASE https://www.crunchbase.com/hub/united-states-finance-companies. The industry trade association has 440 members, *see AFSA Membership,* AMERICAN FINANCIAL SERVICES ASSOCIATION, available at https://afsaonline.org/about-afsa/afsa-membership/.

TABLE 8-1: CONSUMER CREDIT BY TYPE OF HOLDER

	1975 Billions	1975 Percent	2019 Billions	2019 Percent	2019 Excluding Government
Depository Institutions	$116	56.0%	$1,771	42.3%	61.7%
Finance companies	$33	15.9%	$537	12.8%	18.7%
Credit unions	$26	12.6%	$482	11.5%	16.8%
Nonfinancial business	$33	15.9%	$40	1.0%	1.4%
Pools of securitized assets		0.5%	$14	0.3%	0.5%
Federal government		0.0%	$1,319	31.5%	------
Nonprofit and ed. inst.		0.0%	$28	0.7%	1%
	$207	100%	$4,191	100%	100%

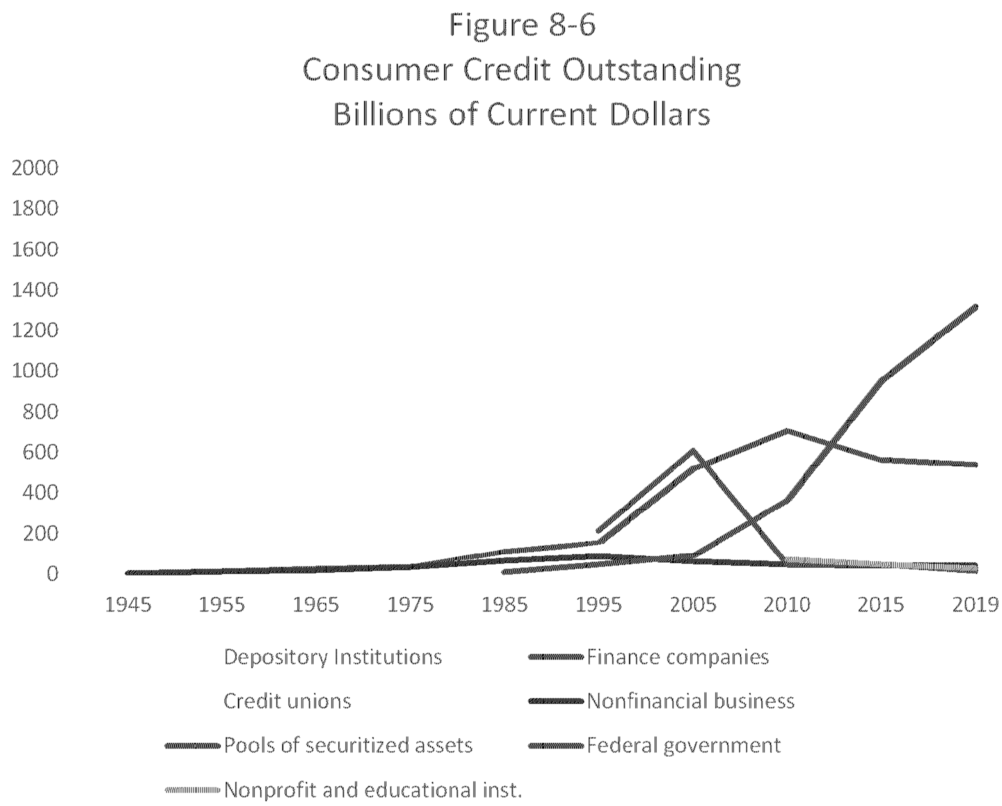
The table reveals an apparent drop in the shares of major types of institutions. For depository institutions (banks, savings, etc.) holdings dropped from 56 percent in 1975 to 41 percent in 2019 (close to their share in 1972). Finance companies and credit unions also lost share over the period, although their declines since 1975 appeared to be more modest. The share loss of nonfinancial businesses accelerated, dropping from about 16 percent to little more than a single point in 2019.

Declining shares of the top three sources should be viewed in light of the increase in consumer credit overall and the emergence of the federal government as a major holder. As shown in the final column of Table 8.1, it was the growth of government-held student loans that reduced the shares of the other sources despite the dramatic growth of the private sector. The federal government did not hold enough credit to warrant tracking at the time of the NCCF's Report, and its share still rounded to zero in 1975. Today, the government is the second largest creditor of consumers, after depository institutions. If its holdings were subtracted from the table, the shares of the traditional institutions would all increase by half. Banks (and savings institutions) would rise to around 60 percent, while finance companies and credit unions would approach 20 percent apiece, all above their shares in the early 1970s.

Expanding aggregate credit has translated into increased holdings for each of the major sectors since 1975. Even nonfinancial institutions, with one-tenth of their 1975 share, hold more dollars of consumer credit than they did 45 years ago (although adjusting for inflation would show a decline). Finance companies and credit unions have reached about half a trillion dollars, while depository institutions are well above a trillion.

Although less severe than the wide shifts in the first half of the century, the variations apparent in the chart continue to suggest inter-sector competition. Some sources of credit have nearly vanished. For example, pools of securitized assets rose from miniscule levels and fell back just as quickly in less than two decades. Banks and credit unions continued their long rise. The latter are now closing in on finance companies, whose shares have fallen over the last 10 years. Figure 8-6 shows these trends.

FIGURE 8-6: CONSUMER CREDIT OUTSTANDING BILLIONS OF CURRENT DOLLARS

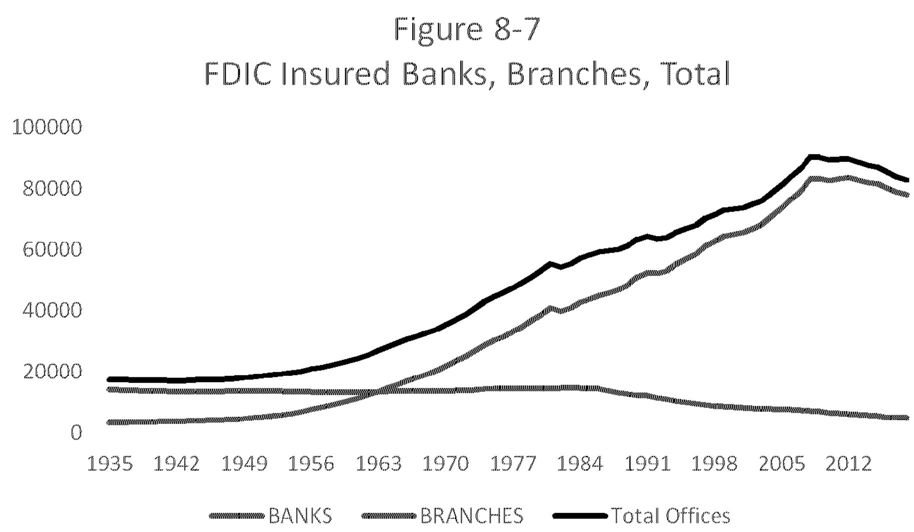


A closer examination reveals forces that have reshaped each sector, and how competition has evolved. Institutions have entered, exited, repositioned, and fought within and across sector borders

8.2.1 Banks

Growing aggregate shares combined with stable or declining numbers of institutions imply that concentration in consumer credit has increased above the levels that the NCCF observed. It is a matter of simple arithmetic. Fewer institutions will account for higher percentages of the whole. Beneath the aggregates, however, is a different picture. While the number of banks did drop by half, the number of branches tripled, from about 25,000 in 1972 to 78,000 today, putting the number of total offices above 80,000. Although the count of total bank offices has declined slightly from its peak of about 90,000 in 2008, the proliferation of outlets remains near historic highs. Figure 8-7 illustrates the trends.[77]

FIGURE 8-7: FDIC INSURED BANKS, BRANCHES, TOTAL



Overall, the trends show that headquarters of financial institutions have declined while total storefronts have expanded, and for consumers, the storefronts matter. Like gas stations and grocery stores, local offices vie for the consumer's business.

[77] *Annual Historical Bank Data*, FDIC available at https://banks.data.fdic.gov/explore/historical?displayFields=STNAME%2CTOTAL%2CBRANCHES%2CNew_Char&selectedEndDate=2018&selectedReport=CBS&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc. The same source shows the number of federally insured S&L's declining from over 3,500 to less than 700 between 1984 and 2018.

Competition in the banking sector is monitored by both the Department of Justice and the Federal Reserve, which share responsibility for reviewing potential competitive effects of bank mergers.[78] To facilitate that effort the Fed collects and publishes structural data on banks and thrifts in markets across the United States. Concentration is measured by an index, called the Herfindahl-Hirschman Index, or HHI, which can range from near zero for a market with thousands of small competitors to 10,000 for a market dominated by one company. The Fed gives close scrutiny to mergers that would significantly increase the index in any market to levels of 1,800 or higher.[79] Mergers that do not move concentration above the threshold and small mergers above it, but which do not significantly change concentration, typically do not raise concerns. Consumers have plenty of options at HHI levels around 2,000.

A few examples of larger and smaller markets illustrate the conditions at different points on the HHI scale. The market that includes Houston, Texas has an HHI near 2,300, indicating concentration above the threshold of scrutiny. Yet the market has 92 commercial banks, which suggests that customers have a plethora of choices. It is because the top four banks have around 70 percent of total deposits that the HHI is relatively high. Columbus, Ohio has a level around 2,100, reflecting 48 banks and nine thrifts.[80] In Fargo, North Dakota, were the level is just under 1,800, customers can choose from 34 banks. El Paso, Texas, with a similar HHI, hosts 14 banks.

Larger markets can accommodate more banks and tend to generate lower scores. The New York City market, for example, with an HHI of 1300, contains 170 banks and 45 thrifts. Chicago, where customers can find 135 banks and 24 thrifts, has an HHI around 950. Even in small metropolitan areas, however, concentration typically remains below 2,000 on the HHI scale. Figure 8-8 tracks average indexes by size of SMSAs, from the smallest areas to the largest in the

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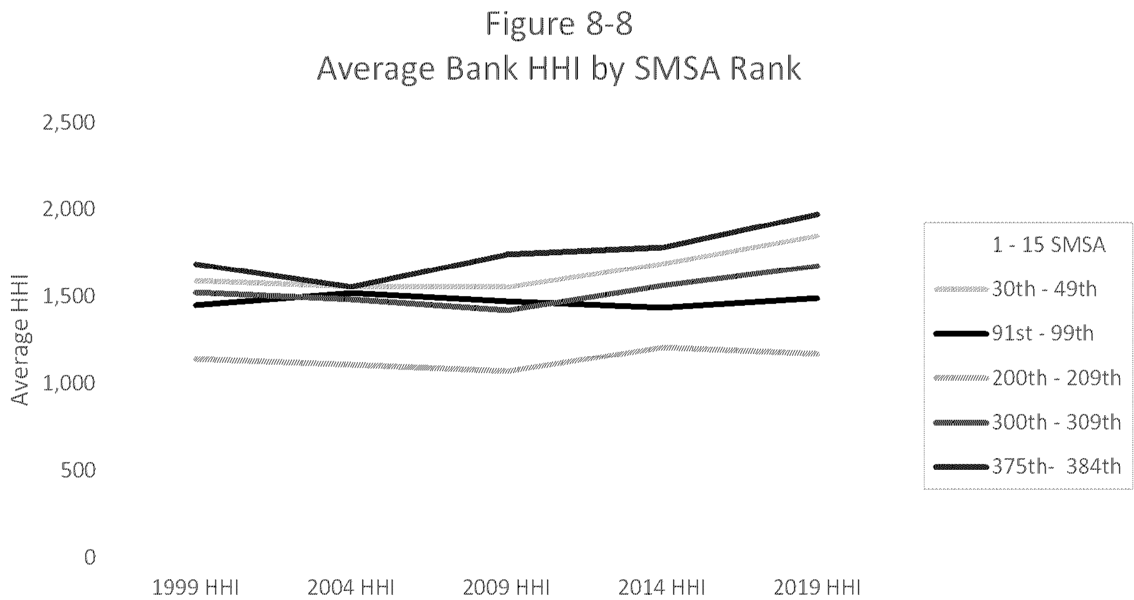
[78] For a description of the reviews, See DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION, HORIZONTAL MERGER GUIDELINES, (2010), available at https://www.justice.gov/atr/horizontal-merger-guidelines-08192010, for a description of the criteria used in evaluating mergers, and DEPARTMENT OF JUSTICE, Bank Merger Competitive Review -- Introduction and Overview (1995) (currently under review), available at https://www.justice.gov/opa/pr/antitrust-division-seeks-public-comments-updating-bank-merger-review-analysis

[79] The Herfindahl Hirschman Index (or HHI), which is the sum of the squares of the percentage shares of the companies in a market. For example, ten companies, each with a share of 10 percent, would result in an HHI of 1,000. The square of 10 is 100, and 100 added ten times equals 1,000. A market comprising five firms of equal size yields an HHI of 2,000 (20 squared x 5). Branches are aggregated by institution, not counted individually. See, e.g., *Competitive Analysis and Structure Source Instrument for Depository Institutions*, ST. LOUIS FED, available at Https://Cassidi.Stlouisfed.Org/Index.

[80] Thrift institutions are discounted by 50% in HHI calculations, in light of their more limited services compared to banks. See How do the Federal Reserve and the US Department of Justice, Antitrust Division, analyze the Competitive of mergers and acquisitions under the Bank Holding Company Act, the Bank Merger Act, and the Home Owners' Loan Act; FAQs, BOARD OF GOVERNORS OF THE FEDERAL RESERVE BOARD, available at https://www.justice.gov/sites/default/files/atr/legacy/2014/10/09/308893.pdf

Fed's database from 1999 to 2019. Concentration, although rising, remains below 2,000 for banks and thrifts in most markets.

FIGURE 8-8: AVERAGE BANK HHI BY SMSA RANK



[81]

Some indications of the future of competition in banking may be evident from the trends in concentration. In both the larger and smaller markets, concentration was relatively stable between 1999 and 2009, but then rose noticeably in the five years between 2009 and 2014. Over the last five years the rise reversed in some of the largest markets but has continued in smaller population centers.

Within the largest metropolitan markets, the trends in consolidation are unlikely by themselves to suggest potential anticompetitive effects. Banking in big cities has become more concentrated but not to the point that raises risks that competition may be suffering. On the other hand, the smaller markets have reached levels that suggest further consolidation could face resistance

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[81] Source: FDIC's Summary of Deposits, Market Share Reports, available at ,https://www7.fdic.gov/sod/sodMarketBank.asp?barItem=2.

1-15 Avg Population 7,240,113

32-49 Avg Population 1,591,927

90-99 Avg Population 622,387

200-210 Avg Population 224,861

300-310 Avg Population 134,483

376-384 Avg Population 67,358

CFPB-0005933

from competition authorities—if that consolidation occurs by merger. There is little the authorities can do to prevent concentration from increasing by attrition, for example when a bank simply exits a market. Both consolidation and attrition are occurring in small markets.

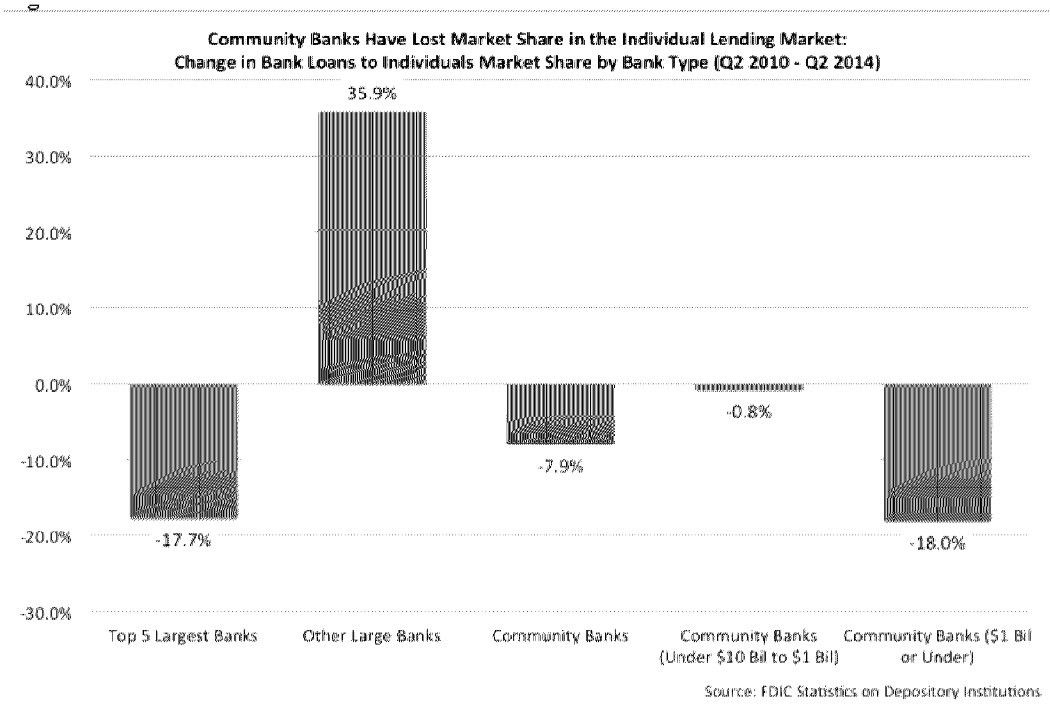
An insight into how the changes in concentration can affect the consumer market was described in a 2015 study on community banks.[82] The authors cited Bureau research that had found community banks "can be a lifeline to hardworking families paying for education, unexpected medical bills, and homes."[83] Business pressure, however, was causing these banks to pull back from consumer lending and focus on commercial loans to local companies. Small banks, research has found, have a comparative advantage over large institutions by virtue of the closer customer relationships that the local setting allows. Despite the advantage, the prospects for those banks remain in doubt as well. A chart from the study depicts a shift in lending to individuals from 2010 to 2014; reproduced as Figure 8-9, the chart shows community banks' lending declining, with the smallest banks' loans declining the most:[84]

[82] Marshall Lux, *The State and Fate of Community Banking February 9, 2015*, M-RCBG ASSOCIATE WORKING PAPER SERIES, No. 37 (2015) available at https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf

[83] Id. (CITING CONSUMER FINANCIAL PROTECTION BUREAU, COMMUNITY BANKS AND CREDIT UNIONS, http://www.consumerfinance.gov/small-financial-services-providers/ (accessed January 10, 2015))

[84] Id., Figure 12, at 19.

FIGURE 8-9: COMMUNITY BANKS HAVE LOST MARKET SHARE IN THE INDIVIDUAL LENDING MARKET: CHANGE IN BANK LOANS TO INDIVIDUALS MARKET SHARE BY BANK TYPE (Q2 2010 – Q2 2014)



The Chairman of the FDIC described the disconcerting trend:

Small banks like these are slowly disappearing from America's landscape. Today, 627 counties are only served by community banking offices, 122 counties have only one banking office, and 33 counties have no banking offices at all.[85]

It bears repeating that market structure is merely the beginning of a competition analysis. Factors other than concentration can elevate or alleviate initial concerns that the measure of firms in a market may raise. In sectors where competitors can increase capacity quickly, as is the case in consumer credit, concentration exaggerates the significance of large firms and underestimates the importance of small firms. Dominant lenders cannot raise rates and count on small competitors to empty their inventory of loans. Another ambiguity in bank indexes stems from their units of measurement. In the Fed statistics, HHIs are based on total deposits,

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[85] Jelena McWilliams, *BankThink/We can do better on de novos*, AMERICAN BANKER, December 06, 2018, https://www.americanbanker.com/opinion/fdic-chairman-jelena-mcwilliams-we-can-do-better-on-de-novos. The NCCF voiced similar concerns when it recommended research to examine "the adequacy of competition in isolated communities – so called "one-bank" towns – to determine whether residents in those areas obtain adequate amounts of consumer credit at reasonable prices." NCCF, *supra* note 5 at 166.

which are at best loosely correlated with the various financial services that banks and thrifts provide.[86] Because banks can readily reallocate funds from one investment to another—for example, from business finance to consumer credit or from mortgages to auto loans—their ability to compete for consumers is not tied tightly to their total assets. As described in Appendix B, banks facing diminished commercial demand during the Great Depression opened new consumer credit departments, emulating smaller finance companies that were expanding their own operations. These dynamic factors mean that concentration measures do not fully capture the competitive threat that small rivals or small operations present to established institutions. The structure of a market at any given moment provides a helpful context to an assessment of competition, but concentration alone is insufficient to support conclusions about competition.

After identifying the contours of a market and the participants in it, a competition analysis typically turns to the conditions of entry. Consolidation, decline, and even the exit of firms from a market may have little impact on competition if new companies can fill the voids left by companies that decline or depart. As described in Appendix B, finance companies opened offices a century ago while authorities were closing others. Mutual savings banks, which were slow to innovate and declined as a result, offer another example.[87] Competitive analysis must therefore consider conditions of entry, as it is a powerful antidote to anticompetitive performance and unsatisfied demand.

Here the evidence is disconcerting for the banking sector. As is apparent in the trends of new charters for FDIC-insured banks, illustrated in Figure 8-5, entry of banks has dropped to the lowest levels in 80 years. After averaging over a hundred a year from 1960 to 2010 – often exceeding 200—roughly two charters a year have been issued in the United States since 2010. The phenomenon could be driven by diminished interest in entering the sector, higher costs of doing so, or a combination of both. It may be that an FDIC-insured charter is not as important an asset as it once was in the provision of financial services. If so, that could explain a declining demand for the charters. However, an alternative hypothesis is that insured banks remain an important component in the competitive environment, but that entry has become so costly that

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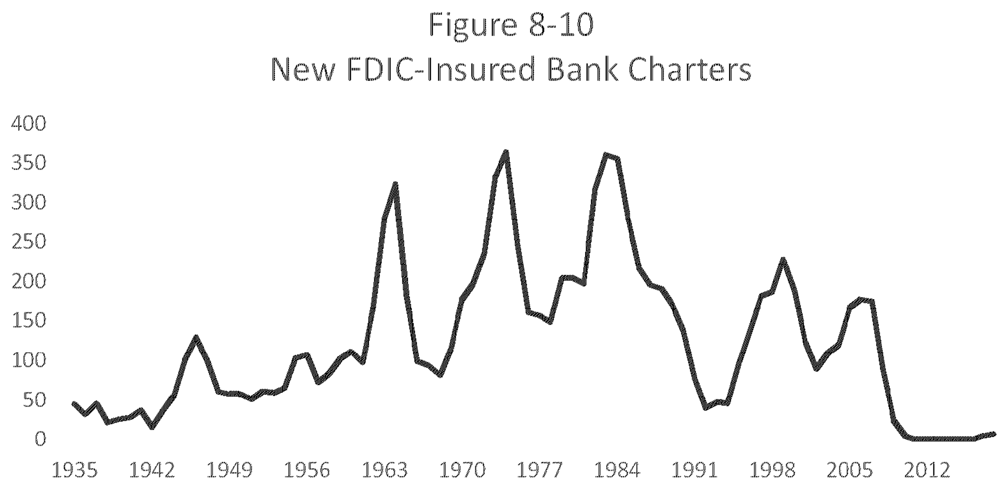
86 A Fed study noted that "HHI is a measure of concentration for the base good, a bank account measured by deposits, and less of a measure of competition for the aftermarkets. Since most bank fees stem from aftermarket good purchases, the standard relationship between concentration and...fees need not apply." *See* Robert M. Adams, *Bank Fees, Aftermarkets, and Consumer Behavior,* FINANCE AND ECONOMICS DISCUSSION SERIES (2017), available at https://www.federalreserve.gov/econres/feds/files/2017054pap.pdf.

87 DANIEL R. WADHWANI, WHY DOES THE US HAVE A WEAK MUTUAL SAVINGS BANKS SECTOR? World Savings Banks Institute (2011), https://www.wsbi-esbg.org/SiteCollectionDocuments/WadhwaniWeb.pdf

efficient providers have been discouraged from taking the opportunity. The most recent data suggest a slight rise in new banks applying for FDIC insurance the past few years, with the annual openings averaging half a dozen in the 2017 to 2019. The trends did not encourage the Chairman of the FDIC who observed that "never before has the level of new banks been so low for so long—only two new startup banks opened between the end of 2010 and the end of 2016, and just 11 have opened since the end of 2009, most in the past 18 months."[88]

FIGURE 8-10: NEW FDIC-INSURED BANK CHARTERS



One more charter could have changed the concentration of depositories dramatically. Walmart has struggled, without success, to enter the sector for years. In the 1990s, it tried to become a thrift holding company, which would have allowed it to open in thousands of American stores. The Bank Holding Company Act restricted companies engaged in nonbank businesses from owning banking subsidiaries, but the option for Walmart to own a subsidiary operating a thrift had a venerable precedent; it was the model that Ford Motor Company, Household International (previously Household Finance Company), and Sears, Roebuck had used to offer financial services to their customers. Before Walmart could execute the plan, Congress passed the Gramm-Leach-Bliley Act of 1999, blocking the move.

A decade later, Walmart tried again, taking advantage of another innovation from the early 20th century. It obtained a charter to operate an industrial loan company (or ILC, like the institutions that once focused on blue-collar customers). Those charters allowed a commercial entity to own

[88] McWilliams (2019), *supra* note 85.

a financial institution that could take deposits and make loans. This time the FDIC blocked the move by denying Walmart deposit insurance, the application for which was "fiercely opposed" by bank lobbies.[89] At public hearings before the FDIC, the American Bankers Association (ABA) complained, "Walmart has begun testing full-service Walmart money centers for using stored-value cards, debit cards and ATMs. It is also rolling out its Money Center Express machines, which will permit customers to use credit or debit cards in a wide variety of ways."[90]

The competition that the ABA opposed did not materialize. The FDIC imposed a moratorium on all ILC applications for deposit insurance in 2006. Walmart withdrew its application in 2007. Any prospect of reconsideration, for Walmart or another company like it, was suspended in 2010, when the Dodd-Frank Act imposed a three-year moratorium on deposit insurance for any new industrial loan company. The moratoriums are typically justified as measures to assess and improve safety and soundness, but there is little evidence that ILCs present more risk than commercial banks, and little dispute that competitor protection plays a role.[91] As the Congressional Research Service put it:

Certain observers, including community banks, have concerns over whether purely commercial or purely banking organizations would be able to compete with combined organizations that could potentially use economies of scale and funding advantages to exercise market power.[92]

With about 4,000 stores, many of which serve customers who are more likely to be unbanked or underbanked, located in communities where banks are more likely to be scarce, Walmart could have introduced financial access to millions and competition to millions more, but it was not able to surmount the barriers to entry that banks had persuaded regulators to build around their business. Despite the setback, Walmart does offer a limited variety of financial services, including smart phone checking with affiliated institutions, but as of 2014, the stores do not

[89] See, Lawrence J. White, *Walmart and Banking: It's Time to Reconsider*," MONEY AND BANKING (May 15, 2017), available at https://www.moneyandbanking.com/commentary/2017/5/13/walmart-and-banking-its-time-to-reconsider.

[90] *Banks fight Wal-Mart's application for bank charter*, ATM MARKETPLACE, (April 20, 2006) https://www.atmmarketplace.com/news/banks-fight-wal-marts-application-for-bank-charter/

[91] See. E.g., Barth, James R. & Sun, Yanfei, 2020. "Industrial banks: Challenging the traditional separation of commerce and banking," The Quarterly Review of Economics and Finance, Elsevier, vol. 77(C), pages 22

[92] Congressional Research Service, "Banking Policy Issues in the 116th Congress" February 21, 2019, https://fas.org/sgp/crs/misc/R45518.pdf.

present the bundle of services available at a typical bank or thrift. Consumer Reports compared Walmart's limited services to those offered by a bank and rated the bank superior.[93]

Academic research described below finds that branch banks bring valuable benefits to underserved areas and populations. These are the services that entry barriers are denying consumers in underserved areas. Lower costs and broader services that competition from Walmart could have brought to consumers were lost when incumbents complained.

Resistance to new entry has not abated. After the FDIC recently approved deposit insurance applications for a payment company and a student loan servicer, bank associations and advocacy groups petitioned Congress to reinstate the Dodd-Frank Act's three-year moratorium on ILC charters. The threat they cited was not the brick and mortar that Walmart had brought to rural counties, but technology that is becoming available everywhere: "In the era of dominant Big Tech, we should be cautious before giving technology companies even greater reach into the economic life of Americans by allowing them to own banks."[94] As ever, entry, the dynamic process that has driven much of the competition in the financial sector, is in jeopardy.

Better data, more sophisticated statistical techniques, and improvements in economic analysis enable more direct assessments than the NCCF could make of the intensity of competition. The banking sector is especially amenable to analyses that go beyond inferences drawn from differences in concentration across states. Numerous studies of bank competition have been published in recent years, the results of which indicate a business where competition has been keen. Reviewing the literature in 1994, Shaffer found that most U.S. banking markets "behave quite competitively at the bank-wide level, even where highly concentrated," although there may be some exceptions in some individual product lines, such as consumer deposit accounts.[95]

In a recent study that tracked the performance of the banking sector from 1984 to 2016, Mendenhall found that its performance exceeded competitive equilibrium levels.[96] He found output of the banks to be "supercompetitive," greater than that expected from competitive markets, and competition did not suffer from the trend of increasing concentration. To the

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93 *Should Walmart be your next bank?* CONSUMER REPORTS (2014) https://www.consumerreports.org/cro/magazine/2014/11/should-walmart-be-your-bank/index.htm.

94 Letter from the Bank Policy Institute, Center for Responsible Lending, Independent Community Bankers of America, to the Honorable Mike Crapo, et al. (July 29, 2020)(The two companies were Square and Nelnet.).

95 Sherill Shaffer, *Bank Competition in Concentrated Markets*, BUSINESS REVIEW (February 1994).

96 Slade Mendenhall, Commercial Bank Competition, Riegle-Neal, and Dodd-Frank, SSRN (2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2967998.

contrary, the evidence pointed toward improving competition. For example, the spread between cost of funds and interest charged actually declined, from 3.3 percent at the beginning of the of the period studied to 2.9 percent at the end.

Most of the competition studies assess banks' overall business, which includes both commercial and consumer lines. Commercial customers are well equipped to impose competitive discipline; they can take their business anywhere in the country and to sources overseas. Whether consumers realized the benefits of competition that these studies have found requires examination of the services they purchase in the market.

There is no question that consumer choices have expanded since the time of the NCCF's Report. Already mentioned are the branches, which grew by the tens of thousands, brought banking to underserved communities, and moved banks closer to consumers in larger markets. Beyond brick and mortar, innovation has provided a growing volume and variety of banking services. The ATM first appeared in 1969. Now ubiquitous, these outlets have grown to an estimated 470,000 in 2018.[97] Banks were the original owners and proprietors of ATMs. Today, fewer than half are bank machines; independent companies operate the remainder. Whether owned by the user's bank, another bank, or nonbank institution, ATMs connect consumers with their banks and many of the services their banks provide. Among the aspects that distinguish independent ATMs: They are more likely to locate in areas with higher unemployment, lower incomes, and lower housing values. Like the consumer lenders of a century ago, independent institutions have found a profit opportunity in bringing financial services to communities where banks are relatively rare.[98]

These developments were made possible by changes in the legal environment of consumer finance, and some of the changes track the recommendations in the NCCF's Report. Restrictions that the NCCF criticized have been amended, repealed or rendered obsolete. Antitrust enforcement has reduced anticompetitive practices. The developments are especially relevant to barriers between institutional segments, geographic markets, interest rate flexibility, loan availability, and lender and servicer performance.

The opening of geographic markets and the competition among institutions would have been impossible without legal reforms of the sort that the NCCF advocated. Pivotal events included a Supreme Court decision in 1978, Marquette Nat. Bank v. First of Omaha Svc. Corp., which

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[97] Lian An, Christopher Baynard, Chiradip Chaterjee, Chung-Ping A Loh, *The Locational Study Of Atms In The U.S. By Ownership* (2018), available at http://www.akleg.gov/basis/get_documents.asp?session=31&docid=22687

[98] The higher transaction fees that independents charge have inspired efforts to cap them. Id.

settled the question as to which state laws would apply to interstate banks; the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which lifted restrictions that states had imposed on banks crossing borders; and the Gramm-Leach-Bliley Act of 1999, which expanded the financial services that banks could offer.[99] The reduction of barriers unleashed the proliferation of branches described above, as banks quickly crossed the borders that previously had confined them.

A summary of the literature on barriers and their effect on competition in banking found that the spread of branches had been painful for some local banks, especially in rural areas, but beneficial for consumers.[100] Empirical analysis documented some of the effects on access to credit:

We first establish the positive effect of interstate branching deregulations on the density of bank branches in poor counties. We find that the density of bank branches increases by around 30% in poor counties after a state fully deregulates.

Second, we show that interstate branching deregulation is associated with a significant drop in the rate of unbanked households among low-income populations. [Illustrative is] the change in the likelihood of holding a bank account in the years before and after deregulation relative to a control group of states that do not deregulate. We observe a significant increase in the share of banked households following deregulation.[101]

Another study found similar effects. Branches that spread after banks were allowed to cross state lines reduced the percentage of unbanked populations in poor communities.[102] The effect was stronger for populations that were likely to be rationed by banks, "such as African American households in 'high racial bias' states, or for households living in rural areas where branch density is initially low."

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99 Marquette Nat. Bank v. First of Omaha Svc. Corp., 439 U.S. 299, 99 S. Ct. 540; 58 L. Ed. 2d 534 (1978) (interpreting the National Bank Act of 1864); H.R.3841 - Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, 103rd Congress (1993-1994).

100 Robert M. Adams and Dean F. Amel, *The Effects of Past Entry, Market Consolidation, and Expansion by Incumbents on the Probability of Entry,* FINANCE AND ECONOMICS DISCUSSION SERIES (2007), available at https://www.federalreserve.gov/pubs/feds/2007/200751/200751pap.pdf

101 Bank Branch Supply and the Unbanked Phenomenon, available at https://pdfs.semanticscholar.org/e9b6/f210629419b5ec6f53f8227448a29dae61f0.pdf?_ga=2.249876995.461538237.1596483228-41928408.1596483228

102 Claire Celerier and Adrien Matray, "Bank Branch Supply and the Unbanked Phenomenon," Draft, October 17, 2016

Legislation and regulations that increase costs or reduce opportunities can compound the challenges facing institutions on the margin of profitability. Considering pressure on banks and credit unions in smaller communities, the US Treasury identified potential effects:

Community financial institutions' business models have come under pressure from a slow economic recovery and low interest-rate environment, additional competition (e.g., internet banks and nonbank lenders), and added compliance costs from new regulations. Together, such factors have contributed to a difficult operating environment and the ongoing consolidation of smaller banks and credit unions....The impact of consolidation has been particularly profound on smaller banks, as the number of institutions with assets less than $100 million declined by 85 percent between 1985 and 2013. Similarly, the total number of credit unions in the country has declined..., with the impact mostly concentrated among smaller credit unions. Feedback provided to Treasury suggests that the cumulative effects of regulatory requirements weigh heavily on community banks and credit unions.[103]

The concerns expressed by the Treasury are reflected in the findings of academic research. Lux summarized research that found bank consolidation increasing after regulatory and legislative changes made operations more costly.[104] Researchers were typically careful to note the difficulty of finding causal links between events and subsequent developments, but the number of studies finding correlations between different regulatory initiatives and changes in banking markets led the author to suggest that regulation was causing consolidation.

The Dodd-Frank Act was expected to raise compliance costs, and those costs could have disproportionately burdened small banks. A 2014 survey reported that more than a quarter of banks with less than $10 billion in assets planned to hire new compliance or legal personnel, while more than a third of banks had already hired new staff to deal with new CFPB regulations.[105] A Minneapolis Fed study that year identified the personnel costs of complying with regulations at banks with less than $50 million in assets. Lux described the findings and a Fed governor's reaction:

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[103] US TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES - BANKS AND CREDIT UNIONS, 56-57 (2017). Available at https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf (footnotes omitted).

[104] Marshall Lux, *The State and Fate of Community Banking February 9, 2015*, M-RCBG ASSOCIATE WORKING PAPER SERIES, No. 37 (2015) available at https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf.

[105] Hester Peirce, Ian Robinson & Thomas Stratmann, *How Are Small Banks Faring under Dodd-Frank?* WORKING PAPER 14-05, THE MERCATUS CENTER AT GEORGE MASON UNIVERSITY (February 2014).

At these institutions, the study found that hiring two additional personnel reduces median profitability by 45 basis points, resulting in one-third of these banks becoming unprofitable. As Fed Gov. Tarullo has noted, "Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets."[106]

Enough time has elapsed since the Dodd-Frank Act to observe more direct evidence of its effects on competition, allowing analysts to examine whether the governor's concerns were justified. Buchak, et al., attributed about 60 percent of the growth of nonbank mortgage lending to increased regulation that banks faced between 2007 and 2015.[107] Mendenhall examined the effects of two major reforms: the Riegle-Neal Act and the Dodd-Frank Act. For a measure of competition, Mendenhall used the spread between cost of funds to banks and interest charged to customers, and he found that the spread dropped (bank competition clearly increased) after Riegle-Neal had allowed interstate banking. The spread continued to shrink after the Dodd-Frank Act added regulatory costs, although the findings with respect to the latter were marginally significant.[108] The author noted that competition might have been even more robust in the last decade without the Dodd-Frank Act, but he could only surmise. Nonetheless, the most recent evidence indicates competition continues to constrain the rates that banks can charge.

Never far from the subject of competition in financial markets is the question whether competition is consistent with safety and soundness.[109] On one hand is the concern that competition will cause banks to make excessively risky loans; on the other is the hope that competition will better serve consumers.

Empirical research offers some insight. For example, one study found that "increased competition induces banks to become more specialized and efficient" but also induces banks to extend credit to riskier borrowers and suffer higher default rates. However, the author did not

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[106]Daniel Tarullo, Speech at the Federal Reserve Bank of Chicago Bank Structure Conference (May 8, 2014)).

[107] Greg Buchak, Gregor Matvos, Tomasz Piskorski, Amit Seru, *Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks* (March 2018) NBER Working Paper No. 23288, https://www.gsb.stanford.edu/faculty-research/working-papers/fintech-regulatory-arbitrage-rise-shadow-bank. (Regulation included capital requirements and litigation. Thirty percent of the growth was attributed to technology.) See also, Consumer Bankers Association, Comment Letter in Response to Request for Information to Assist the Taskforce on Federal Consumer Financial Law (June 1, 2020) https://beta.regulations.gov/comment/CFPB-2020-0013-0089, (playing field tilted against traditional banks).

[108] Mendenhall (2017), *supra* note 96.

[109] The debate was joined by Adam Smith in 1776. (See appendix.)

reach a definitive conclusion as to soundness. Her qualified conclusion was that the competition was "possibly creating a less stable financial system."[110]

Another study found that in competitive mortgage markets, local banks lowered their lending standards by twice as much as those in concentrated markets, but the pressure did not appear to affect standards at national banks.[111] Implications about soundness were accordingly qualified.

A third study found that both national and local banks reacted to changes in competitive conditions.[112] Assessing the effect of the preemption of state regulations by the Office of the Comptroller of the Currency (OCC), the authors compared mortgage lending in formerly restrictive states with lending in states that had imposed more limited rules. After the lifting of restrictions, national banks increased originations of riskier loans—for example, with deferred amortization or interest-only payments. Local banks followed suit, but only in counties where OCC banks were more concentrated. The changes resulted in lower interest rates for some borrowers and new credit to borrowers who would not have qualified for mortgages before the regulatory change.

Easing standards does not necessarily imply imprudent lending. Loans may be just as sound even though extended to applicants who may not have qualified under stricter standards, if the more accessible standards are based on superior efficiency and risk assessment. Competitive discipline can instill both, as one study found. It analyzed direct evidence of prudential concerns and found competition positively correlated with financial stability.[113] Banks in competitive states were less likely to be targeted for regulatory enforcement and less likely to fail. Banks

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[110] Gissler, et al., *The Effects of Competition in Consumer Credit Markets, WP 12-24*, CONSUMER FINANCE INSTITUTE (2018), available at https://doi.org/10.21799/frbp.wp.2018.24.

[111] Xiaochen Feng, *Bank Competition, Risk Taking and their Consequences: Evidence from the U.S. Mortgage and Labor Markets*, IMF Working Papers (2018), available at https://www.imf.org/en/Publications/WP/Issues/2018/07/06/Bank-Competition-Risk-Taking-and-their-Consequences-Evidence-from-the-U-S-46034

[112] Di Maggio, Kermani, and Korgaonkar, *Partial deregulation and competition: Effects on Risky Mortgage Origination*, MANAGEMENT SCIENCE (2019). 10.1287/mnsc.2018.3060 https://www.researchgate.net/profile/Sanket_Korgaonkar2/publication/327834191_Partial_Deregulation_and_Competition_Effects_on_Risky_Mortgage_Origination/links/5ba80a8b45851574f7e19b11/Partial-Deregulation-and-Competition-Effects-on-Risky-Mortgage-Origination.pdf

[113] Akins et al. *Bank Competition and Financial Stability: Evidence from the Financial Crisis. Journal of Financial and Quantitative Analysis*, 1-28 (2016). https://doi.org/10.1017/S0022109016000090.

facing more competition earned lower-interest margins, made fewer high-risk investments, had lower profitability, and held less cash and Tier 1 capital than banks facing less competition.[114]

For these reasons, the implications of consolidation continue to merit careful consideration. Competition could be a cause, a consequence, or both, of consolidation. Likewise, consolidation could be salutary, neutral, or deleterious to competition. It is important to detect the distinctions and directions of causation, if any, in order to avoid false diagnoses and prescriptions that could fail to remedy problems or, worse, exacerbate them. It is even more important to discern as directly as possible the intensity and effect of competition itself, and to assess the external conditions that can affect it.

8.2.2 Credit Unions

As for credit unions, despite the shrinkage of federally insured entities to 5,200, the Bureau of Labor Statistics counted 17,000 total establishments in 2019, much closer to the 1972 tally in the NCCF's Report.[115] Like banks, credit unions have increased lending significantly over the past fifty years, even though the number of institutions has dropped. And as with banks, a simple institutional census of credit unions underestimates their competitive presence. Branching has kept the number of offices near their 1970 levels, and credit unions have become closer alternatives to banks and thrifts for consumer services. Credit unions take deposits, lend to consumers, issue cards, and finance purchases. Not surprisingly, studies find evidence of this competition in the rates that the institutions charge when they operate nearby one another. One study found that when credit unions were more prevalent in a market, credit card loan rates fell.[116] Another study, looking at regulation that allowed credit unions to compete more closely with banks, found that the increased competition was especially beneficial for low-income borrowers.[117] The cost of borrowing fell, banks became more efficient, and both banks and nonbank lenders extended more credit to riskier borrowers.

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114 Id.

115 Bureau of Labor Statistics, Quarterly Census of Employment and Wages, available at https://data.bls.gov/cew/apps/table_maker/v4/table_maker.htm#type=1&year=2019&qtr=4&own=5&ind=522130&supp=0

116 Feinberg, R., *Credit Unions: Fringe Suppliers or Cournot Competitors?* REVIEW OF INDUSTRIAL ORGANIZATION, 20(2), 105-113, (2002).

117 Gissler, et al (2018), *supra* note 110.

By the critical measure of the price of services, credit unions often beat banks, as they did when the NCCF studied the sector 50 years ago. Interest rates on credit cards averaged between 11 percent and 12 percent at credit unions, lower than average bank-card rates.[118] Other loans tend to be cheaper at credit unions as well. These advantages help explain why credit unions have seen their holdings of consumer credit grow faster than banks. Membership in credit unions passed 120 million members in 2019, an increase of about 50 million in 20 years.[119]

Some sizeable differences in the institutions play a role in the competition between the sectors. In credit unions' favor is their tax status. They are nonprofit entities, owned by their members, and therefore have lower tax expenses. In banks' favor is scale. They hold three times as much consumer credit on average as credit unions do, and credit unions are restricted to the consumer channel. The limitation means that commercial banks have the benefit, and of course bear the risk, of other holdings as well. Credit unions tend to be more regional and limited to members of identified organizations, although they do vary in size and geography. Large credit unions operate through branches, ATMs, and online across the country.

Banks and credit unions routinely measure themselves against each another. The institutions conduct annual surveys, which make headlines in the trade press. The most recent survey released by the American Bankers Association announced that for the first time, banks had beaten credit unions in customer satisfaction scores. The headline read, "Banks Outpace Credit Unions in Consumer Satisfaction."[120] Banks did especially well with consumers' ratings of staff, mobile apps, and speed of in-branch transactions. The best of all were regional and community banks, which outscored nationwide banks. While these results support the proposition that banks and credit unions compete closely with each another, they also demonstrate that the bundle of services both types of institutions provide, from personal relations to branch locations, gives them a significant advantage in retaining customers. Consumers may change credit cards, open new accounts elsewhere, or shop nationwide for loans and mortgages, but the established relationships with banks and credit unions are not often abandoned.

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[118] *Credit Union and Regional Bank Credit Cards*, CREDITCARDS.COM, available at https://www.creditcards.com/credit-union/. (The biggest advantage of a credit union credit card? It likely has significantly lower interest, possibly even offering rock-bottom interest on cash advances. In November 2018, the average interest rate offered by credit unions for credit cards was 11.1%, a steady figure over the last 10 years. That compares to the national average rate of 17.08% in March 2020."); See, also, https://www.spglobal.com/marketintelligence/en/about/.

[119]Monthly Estimates, CUNA.ORG (June 2020) available at https://www.cuna.org/uploadedFiles/Global/About_Credit_Unions/CUMonthEst_Jun20.pdf.

[120] *Banks Outpace Credit Unions in Consumer Satisfaction*, ABA BANKING JOURNAL (2019), available at, https://bankingjournal.aba.com/2019/11/banks-outpace-credit-unions-in-consumer-satisfaction/.

Competition between banks and credit unions is also apparent in the rivalry of their respective organizations. The two sectors are frequently at odds over public policies that might give one or the other an advantage. Bankers' associations have opposed allowing credit union acquisitions of banks, allowing credit unions to expand loans to businesses, and allowing other extensions that threaten traditional bank business lines.[121] The banking sector criticizes as unfair the tax advantage of credit unions and cites it as a justification to limit their activities. Credit unions object to restrictions such as caps on commercial lending, which would allow them to enter more areas of competition with banks. It is not necessary to take a position on these arguments to conclude that the debate itself reveals potential competition between the two sectors. Evidence discussed below reveals other aspects of sectors' rivalry. The barriers against credit-union expansion harken back to those that the NCCF deemed anticompetitive 50 years ago.

8.2.3 Finance Companies

Finance company establishments numbered just under 16,000 in 2019[122] ahead of the 13,000 to 14,000 offices estimated by the NCCF in 1970. For decades, with portfolios of direct and indirect loans, finance companies constituted the second largest sector of nonmortgage consumer credit. They offer a variety of loans for the purposes that send consumers to banks, credit unions, and retail lenders.[123] Although this sector has lost share to banks and credit unions since 1972,[124] it does not appear to be in decline. To the contrary, according to a report from Experian, finance companies are the fastest growing source of consumer credit, having increased by 50 percent in the past five years. For 2019, the report estimated that 11 percent of the population held 34.8 million different accounts and 6 million new accounts at finance companies.[125]

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[121] *See*, e.g. Melissa Angell, *Banks decry CU lobbying while beefing up own during coronavirus,* AMERICAN BANKER (May, 18, 2020), available at https://www.americanbanker.com/creditunions/news/banks-decry-cu-lobbying-while-beefing-up-own-during-coronavirus; *see also* Carrie Hunt, *The difference between banks and credit unions could not be clearer,* THE HILL, (February 5, 2019), available at https://thehill.com/opinion/finance/428546-the-difference-between-banks-and-credit-unions-could-not-be-clearer..

[122] BUREAU OF LABOR STATISTICS, QUARTERLY CENSUS OF EMPLOYMENT AND WAGES (2019, available at https://data.bls.gov/cew/apps/table_maker/v4/table_maker.htm#type=1&year=2019&qtr=4&own=5&ind=522291&supp=0

[123] DURKIN et al. (2014), *supra* note 65, at 25.

[124] Statistical Release, Finance Companies (June 2020), available at https://www.federalreserve.gov/releases/g20/current/g20.pdf.

[125] Matt Tatham, *Personal Loan Debt Continues Fast-Paced Growth*, EXPERIAN, October 14, 2019, available at https://www.experian.com/blogs/ask-experian/research/personal-loan-study/.

Innovation is driving this growth. According to the Experian report, FinTech lenders, continuing to offer new products and experiences, "have more than doubled their market share of unsecured personal loans in the past four years, from 22.4 percent in 2015 to 49.4 percent in 2019."[126] By 2022, FinTech lenders are expected to increase those loans by another 50 percent. Whether FinTech lending meets the expectations of the analysts, its competitive presence is unquestionably established, and the comparative advantage of offices and branches is declining.

Although the sources of personal loans are new, consumers' borrowing patterns are familiar. A 2019 Experian survey of consumers reported that 28 percent had used their personal loans for large purchases, 26 percent for debt consolidation, 17 percent for home improvements, and 9 percent to refinance existing debt.[127] In one important respect, consumers clearly have gained on past generations: The average annual percentage rate of 9.4 percent in 2019 was less than half the finance-company rates that the NCCF observed in 1972 (when prime rates were comparable). APRs found in this survey beat the rates that the NCCF found credit unions and banks charging 50 years ago.[128] Credit union members in 2019 still cited better rates as a reason for borrowing there.

Like banks and credit unions, finance companies range from smaller, local establishments to cross-country networks. Many, including industry leaders, extend credit entirely online. They offer personal loans, mortgages, auto loans, and other types of credit. Banks regard them as attractive acquisitions. In September 2020, the appeal of finance-company acquisitions was described in the "American Banker," which reported that "card networks, along with PayPal and Citi, are responding to competition from the likes of Affirm, Afterpay and other "buy now, pay later" lenders. Should traditional credit card lenders be worried?"[129] The answer to this rhetorical question was not necessary to reveal. For personal finance loans at least, product distinctions do not raise a high barrier between the sectors. Enthusiasm among banks for finance-company acquisitions remains keen, and the reason is the ability of finance companies to take business away from other types of institutions.

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[126] Id.

[127] Stefan Lembo Stolba, "Survey: Consumers Want Personal Loans for Large Purchases and Debt Consolidation, September 16, 2019, https://www.experian.com/blogs/ask-experian/survey-consumers-want-personal-loans-for-large-purchases-and-debt-consolidation/.

[128] NCCF (1972*), supra* note 5, at 128. (In 1972, credit unions charged - 11.76%, banks - 13.04%, and finance companies - 25.88%. The prime rate fluctuated around 5% in both 1972 and 2019.)

[129] Kevin Wack, *Why Visa and Mastercard are suddenly keen on installment lending*, AMERICAN BANKER, (September 02 2020), available at https://www.americanbanker.com/tag/consumer-lending

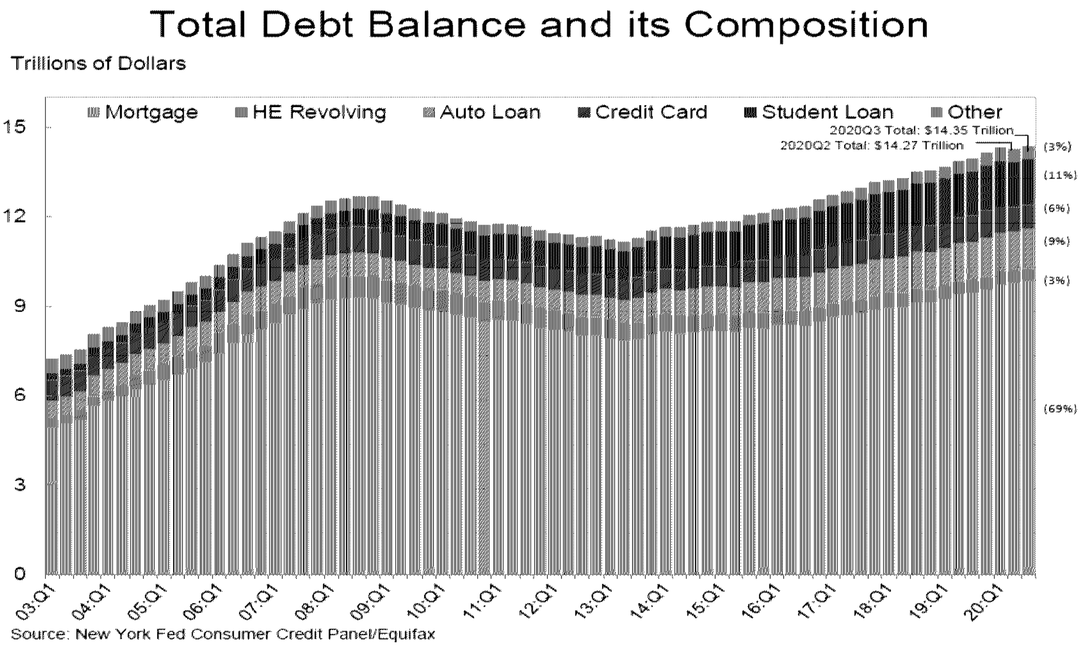
In short, the border between banks and finance companies does not appear to be a natural barrier, at least where loans are concerned. A century ago, banks began to open consumer-finance divisions and offer products that emulated finance-company loans. In 1972, the NCCF reported on banks' buying finance companies for the same reason. Acquisitions, rather than internal growth, became a more attractive way to compete because regulations prevented banks from offering the terms that finance companies could offer. Today, the finance-company sector remains an inviting business for entry from the banking sector.

8.3 Competition from the Consumer's Perspective

Consumers are constantly shopping for credit. They open 200 million accounts on average every 12 months, while they close another 200 million. This turnover represents more than a quarter of all accounts outstanding. In 2020, consumers held about 500 million credit card accounts, 100 million auto loans, 75 million mortgages, and about 20 million home equity lines of credit. Their holdings amounted to $14.35 trillion in the third quarter of 2020, about twice the level of 2003, as Figure 8.11 shows.[130]

FIGURE 8-11: TOTAL DEBT BALANCE AND ITS COMPOSITION

[130] NEW YORK FED, QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT, 20 20:Q3 (November 2020) https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2020Q3.pdf.



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The assessment of competition typically begins with a definition of the market, which means taking the perspective of consumers and determining what they would regard as suitable substitutes for a product or service they desire.[131] Because financial services facilitate the consumption of something else, demand for those services is shaped by the ultimate purposes a consumer has in mind. Chapter 3 explains that for both borrowing and saving, a significant consideration is the time horizon—how long a consumer wants the use of a loan or when a consumer wants to retrieve funds deposited for future spending. Short-term loans and time deposits are more likely to be the leading options for consumers with temporary needs or seasonal shopping. Longer terms likely work better for home mortgages and retirement savings. Other aspects of a financial transaction bear on substitutability as well. Price, convenience, and customer service may make dissimilar products more or less appealing to a shopper with a particular purpose in mind. When significant time is not involved—for example when financial services simply facilitate payments—the most important features are likely to be reducing the costs and enhancing the efficiency of transactions.

[131] The process of market definition is described in merger guidelines issued by enforcement agencies. See DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION, HORIZONTAL MERGER GUIDELINES, (2010), available at https://www.justice.gov/atr/horizontal-merger-guidelines-08192010.

Consumers use some financial services that they do not choose directly. While they select their lenders and depository institutions, the services they consume include components that the vendor has chosen. Just as a car owner may not know who produced the mechanics or body parts of an automobile she has just purchased, borrowers may not be aware of the companies that sell services that support a loan they have just taken out. A borrower does not select the credit reporting agency that provides information on his credit history or the loan servicer who collects payments. Nonetheless, the costs and quality of these services affect the price and availability of the loan. Accordingly, this chapter will consider competition in services provided in markets where financial institutions shop.

Few (if any) clear distinctions exist among the lengths that loans can run. Some credit needs expire in days, while others may extend for weeks, months, or years. Likewise, some credit products are designed for shorter or longer periods, while others can meet needs of almost any duration. Terms, of course, are not determinative. A longer loan at a lower rate may be a good substitute for a shorter loan at a higher rate. Accordingly, a competitive analysis should not conclude until the most determinative aspects of financial services are taken into account.

Because credit is fundamentally about accelerating or postponing purchases – whether for emergencies that require immediate payment, home prices that exceed available cash, saving for retirement, or myriad other decisions – this analysis will begin with the time dimension and then consider the other factors. The analysis will cover three general categories: short-term, medium-term, and long-term credit. We expect to find that borrowers in the market for short-term credit will look at products designed to meet those needs. A loan to repair the car until the next paycheck will likely come from a short-term or medium-term source. A loan to finance a house or car purchase will likely come from a provider of multi-year loans. Within each category, the analysis will consider the offers available to consumers and the competition among providers extending those offers. It is possible that the evidence will reveal that some products within each group do not compete in all respects with one another, and equally conceivable that the products in some groups compete with other products outside the groups.

Even within the groupings, different products offered by different institutions may be sufficiently distinct that they do not compete meaningfully with one another. As the NCCF observed, loans from remote sources may not provide a competitive constraint on convenient outlets, even when the loans may have similar features. Second mortgages can and do finance car purchases, for example, but the vast majority of cars are financed by automobile loans.[132] Consumers can and do reallocate debt by delaying a payment to one creditor to obtain funds for another purpose, but those options may impose greater costs. In most cases, however, the leading edge of competition will come from providers more closely situated within categories.

Financial services can be customized in numerous ways. Terms depend on the information that borrowers and lenders bring to the transactions, their respective bargaining skills, economic expectations, credit history, and attitudes toward risk. All those contribute to an assessment of the likelihood that the borrower will repay the loan. Because borrowers vary widely on that spectrum, and because financial services are personal transactions, terms and services can be tailored to individual borrowers.

The most important influences on affordability and availability are the credit histories and credit scores of borrowers. Although several scores are available (the market for credit scoring is discussed below), the most frequently used measure is a FICO Score from the Fair Isaac Corporation. Table 8-2 below lists consumers within each FICO group and Table 8-2 lists types of credit by maturity. Creditors are more likely to lend and more likely to give favorable terms to consumers in better risk categories. Borrowers with poorer FICO grades will find fewer choices in the marketplace. Borrowers with the poorest scores or insufficient credit history to generate any score at all, will have even fewer choices.

According to one study, about a third of Americans have a FICO Score below 669, often considered "subprime" scores by lenders, and about half of them are classified as "very poor" (although that lowest category is no longer publicized). For comparison, the 67 percent of consumers who hold credit cards and the 62 percent who have retailers' cards have average scores in the low 700s.[133]

TABLE 8-2: PERCENT OF AMERICANS BY FICO© GRADES AND SCORES 2019[134]

FICO Grade	Score	Share of Total

[132] 85% of new cars; 55% of used cars financed, *see* Melinda Zabritski, *State of the Automotive Finance Market*, EXPERIAN, Q4 (2019), available at https://www.experian.com/content/dam/marketing/na/automotive/quarterly-webinars/credit-trends/2019-q4-state-of-the-automotive-finance-market.pdf.

[133] Matt Tatham, *2019 Consumer Credit Review*, EXPERIAN, (January 13, 2020) (The average credit card debt for Americans reached $6,194 in 2019, as balances increased 3% compared with 2018, according to Experian data. The average FICO® Score for consumers with a credit card is 727, and 67% of Americans carried a credit card in 2019. https://www.experian.com/blogs/ask-experian/consumer-credit-review/.

[134], *MyFICO*, FICO, available at https://www.myfico.com/credit-education/credit-scores.

Poor	300-579	16%
Fair	580-669	18%
Good	670-739	21%
Very good	740-799	25%
Exceptional	800-850	20%

TABLE 8-3: RETAIL CREDIT PRODUCT GROUPINGS

Short Term	Medium Term	Longer Term
Pawns / Title Loans	Credit Cards	Auto Loans
Small Dollar Loans Payday Loans	Installment loans	Installment loans
Overdraft Protection	Overdraft Line of Credit	Mortgages
Credit Cards		

Credit scores rise with the age of consumers. A breakdown by cohorts was reported by Experian, using VantageScore—a joint product of the three national credit bureaus, which is comparable to the FICO Score. For Gen Z, the average is 656; Gen Y, 658; Gen X, 676; boomers, 716; and the Silent Generation, 729.[135] In other words, two generations of Americans have yet to raise their average credit risk to good or better, and the average obscures the circumstances of the constituents; every generation has at any time some members struggling with credit status. Because below-average grades limit borrowers' options in the market for financial services, the competition they encounter can vary substantially.

[135] Stefani Wendel, *State of Credit 2020: Consumer Credit During COVID-19*, EXPERIAN. Available at https://www.experian.com/blogs/insights/2020/10/state-credit-2020/. VantageScore breaks the bottom range into two categories – deep subprime (or bad credit) from 300 to 499 and poor credit from 500 to 600.

8.3.1 Short-Term Loans – Overdrafts, Payday Loans, Pawnshops, Personal Loans

Most borrowers need not look for short-term loans, because they have alternatives available from numerous sources and can tap them as easily as swiping a credit card. Anyone who has a credit card can obtain an advance for 15 days, a few months, or a few years, and people with FICO Scores in the mid-600s or above can typically qualify for cards—Their options for short-term loans are virtually unlimited.

For consumers with the lowest scores or thinnest files, however, the options are more likely limited to short-term, small-dollar loans. Low-income and thin-file consumers, like their predecessors a century ago, often unbanked or underbanked, may have to choose among the lenders that specialize in short-term credit. These are the businesses that make installment loans, pawn loans, vehicle title loans, and payday loans. As noted in Chapter 3, these products together amounted to about $75 billion in recent years, a small fraction of the $4 trillion in consumer debt outstanding. Similarly small is the proportion of households using these loans; it is under 2 percent for each type.

Nonetheless, providers are abundant, counting in the tens of thousands, and the sector is sometimes criticized for being *too* competitive. A common comment about the estimated 18,000 payday lenders is that they are more ubiquitous than McDonald's or Starbucks.[136] Indeed, a payday loan office requires less capital and fewer employees than a typical McDonald's restaurant impeded. Those restrictions aside, entry barriers would be nonexistent, which explains why the number of providers, like their counterparts in the early 20th century, remains high.

In addition to payday lenders, borrowers with few other options have access to some 10,000 pawnshops according to the National Pawnbrokers Association. Significant overlaps exist in product characteristics and prices among pawnshops, payday lenders, and overdraft protection services. Some research has found rates to be comparable,[137] which suggests the three may be in one market. A study of alternatives to payday lending in Ohio, after legislation capped payday

[136] Tim Ranzetta, *Which business has the most physical locations in the US: McDonald's, Payday Lenders, or Starbucks?*, NGPF (2019), https://www.ngpf.org/blog/question-of-the-day/qod-which-business-has-the-most-physical-locations-in-the-us-mcdonalds-payday-lenders-or-starbucks/

[137] Not found in the resources reviewed to date is an accounting for the cost of convenience of the three options. Payday convenience for example, may be worth more than the difference interest payments, while security forfeitures, if factored into interest rates, would increase borrowing costs at pawnshops.

rates at 28 percent and caused payday lenders to shut down, found that pawnshop licenses grew by 97 percent.[138] Discussed later in this chapter, the ability of banks to compete for small-dollar, short-term loans has been hampered by regulations discouraging such loans and limiting overdraft charges. P2P, friends and family may be available to consumers who cannot access banks and finance companies, but these informal sources are beyond the scope of this chapter.

On the question whether payday loans compete with other types of loans, Durkin, et al. report that significant interinstitutional competition arose after the relaxation of rate ceilings and other restrictions in the 1980s and 1990s.[139] Evidence for that competition was described in a 2013 article:

Competition benefits consumers in the alternative consumer credit markets just as it does in any other market, providing consumers with the opportunity for lower prices, innovation, and higher-quality service. Although prices seem high for both payday loans and overdraft protection, there is no evidence that either product generates sustainable economic profits (as opposed to normal economic returns). Payday loan prices generally reflect underlying risk and operating costs. There is no evidence of supranormal economic (or monopoly) returns to firms in the payday lending industry, indicating the competitive nature of the market. Barriers to entry in the payday lending market appear to be low.[140]

Competition between payday lenders and less expensive sources of credit might be more robust but for barriers that have prevented entry into the payday space. In 2003, OCC discouraged banks from offering short-term, small-dollar loans. When banks tried to compete anyway—for example, by offering overdraft protection—the Fed restrained those efforts with additional restrictions in 2009. The effects were immediate, according to Evans, Litan, and Schmalensee, who found, "within days" of the Fed's announcement of its new overdraft rules, banks started scaling back access to checking accounts, which meant diminished availability of credit services associated with them, such as deposit advance.[141]

Still, banks have demonstrated that entry is difficult to suppress in markets where consumers are paying high prices. Community banks and credit unions have offered variations of payday

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[138] Stefanie R. Ramirez, Payday-loan bans: evidence of indirect effects on supply. Empir Econ 56, 1011–1037 (2019). https://doi.org/10.1007/s00181-018-1447-2 (Licenses for small-loan companies increased by over 150%.)

[139] DURKIN et al. (2014), *supra* note 65, at 506-509.

[140] Clarke and Zywicki, Payday Lending, Bank Overdraft Protection, And Fair Competition At The CFPB, REVIEW OF BANKING & FINANCIAL LAW, Vol. 33, No. 1, pp. 235-281, at 258 (2013).

[141] Id. at 263 (citations omitted).

loans for several years, and more recently, large banks have introduced similar products. Since 2018, US Bank has offered loans of $100 to $1,000 at fixed fees of $12 to $15 per $100, and Bank of America is currently rolling out a plan with a $5 flat fee for loans of $100 to $500. Both plans allow three months to repay. APRs on those loans depend on their duration, since quicker repayments raise rates, but borrowing costs over three months can translate into substantial savings over payday and other small-dollar loans—about 70 percent for US Bank and 6 percent to 30 percent for Bank of America, compared with an average of 90 percent for installment loans under $1,500 and 400 percent for a typical payday loan.[142] Some banks still offer overdraft protection and direct-deposit-advance products that may compete with small-dollar lending.[143] Consumers who opt in to such services tend to be credit constrained: Compared with others, they have lower credit scores, are less likely to have a general-purpose credit card, and are more likely to have low limits on cards they do have.[144] Payday borrowers display similar profiles. In markets where banks offer those products, borrowers may benefit from the additional competition. And some credit unions offer payday alternative loans, or PALs, which typically run for longer terms at lower rates.[145]

Online information available to consumers suggests that pawns, personal loans, and payday loans may be alternatives to one another. According to Credit Karma, a marketer that combines advertising with advice, the average pawnshop loan is $150, and pawnshops are no longer confined to inconspicuous storefronts and strip malls. Online sites will pawn items worth hundreds (or, they claim, millions) of dollars. For consumers considering a pawnshop, however, Credit Karma, a marketer that combines advertising with advice, suggests web-based peer-to-peer options, negotiating extensions with current creditors, and approaching neighbors and friends. In a clue that payday loans are another alternative to these sources, Credit Karma cautions against the payday option because it is "terribly costly." [146] With the advice comes

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[142] See, e.g. Lisa RowanForbes , "New Small-Dollar Loans From Bank Of America Offer Alternative To Expensive Payday Loans," Forbes Advisor Oct. 14, 2020, https://www.forbes.com/sites/advisor/2020/10/14/new-small-dollar-loans-from-bank-of-america-offer-alternative-to-expensive-payday-loans/?sh=6b89ae892306.

[143] CFPB, CFPB STUDY OF OVERDRAFT PROGRAMS: A WHITE PAPER OF INITIAL DATA FINDINGS (June 11, 2013), available at https://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf. ("Between 20% and 27% of accounts opened in 2011 had one or more overdraft or NSF transaction. ...Between 13.5% and 27.8% of accounts with at least one overdraft or NSF transaction had at least 10 such transactions.")

[144] CFPB, DATA POINT: FREQUENT OVERDRAFTERS (Aug. 4, 2017), available at https://www.consumerfinance.gov/documents/5126/201708_cfpb_data-point_frequent-overdrafters.pdf.

[145] Liz Weston and Amrita Jayakumar, *What Is a Payday Alternative Loan?* NERDWALLET (December 3, 2019) available at https://www.nerdwallet.com/article/loans/payday-alternative-loan-pal

[146] Anna Baluch, "*Is a pawn shop loan a good idea for quick cash*?" Credit Karma, *?* CREDIT KARMA (Updated July 19, 2019,), available at

advertising for numerous short-term and medium-term loans for the consideration of the potential payday shopper. Information about products and providers is plentiful on the site, one of many that borrowers can check for alternatives to payday loans.

Payday loans and similar products may be costly, but cost depends on context and by itself reveals little about competition. McDonald's and Starbucks charge more for food and drink than other chains, but less than full-service restaurants, most of which contend with constant competition.[147] No restaurant, however, would make economic sense to consumers as a sole source for food or coffee. By the same token, a hotel room would not make sense as a yearlong residence, even though competition and depressed travel have pushed the average nightly rate down to $100 in the U.S. in 2020. A $100 nightly rate is a bargain by historical standards, but it translates into an annual cost of $36,500, quite expensive for a studio apartment without a kitchen. Paying seemingly exorbitant annual costs of an occasional product or service does not necessarily indicate misguided consumers or malfunctioning markets.

Surveys of payday loan borrowers conducted by The Pew Charitable Trust and Advance America (one of the country's largest payday lenders), found that consumers consider various options to obtain short-term credit, including skipping payments to existing creditors, borrowing from family, overdrawing their bank account, and taking out a small-dollar loan.[148] Academic research described in Chapter 10 has found that bans on payday loans cause customers to shift to these options, and in states that ban the loans consumers cross borders to borrow if neighboring states permit them.[149]

That consumers resort to alternatives does not necessarily indicate that they are close substitutes. When a service is unavailable altogether, consumers may settle for inferior options that they would not have chosen in a competitive market with numerous options. A survey commissioned by the industry lends some support to the superiority of payday loans over their closest alternatives. Nearly 75 percent of the small-loan or payday borrowers surveyed said they

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https://www.creditkarma.com/personal-loans/i/pawn-shop-loans/.

147 See, e.g. Andrea Marie Leschewski and Dave D. Weatherspoon, Fast Food Restaurant Pricing Strategies in Michigan Food Deserts, International Food and Agribusiness Management Review Volume 17 Special Issue A, 2014, (surveying literature).

148 See, e.g. The PEW Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, (2012) , available at https://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why; Advance America, *Release, 92% of Borrowers Choose Payday Loans Over Competing Credit Products*https://www.advanceamerica.net/news/92-of-borrowers-choose-payday-loans-over-competing-credit-products.

149 See, e.g. Ramirez, *supra* note 138.

could not find an alternative when they took out their last loan.[150] These are borrowers who either had reached their credit limits or could not secure credit cards, installment loans, second mortgages and other loans offering more attractive terms. For people in these circumstances today, like the small-dollar borrowers of a century ago, competition within the sector can offer consumer protection, and innovation could dramatically reshape competition in the sector. Banks' continue to enter the space, and nonbank payment systems are beginning to bridge the gap between credit invisibles and financial institutions that can lend at much lower costs. These developments are described at the end of the chapter.

8.3.2 Medium-Term Credit – Credit Cards, Lines of Credit, Installment Loans

For consumers who are considered good-to-excellent credit risks, the marketplace for financial services is vast, including multiple medium-term credit instruments, and it is this category that has been the largest contributor to the growth of nonmortgage consumer credit held by banks. Credit cards account for most of that growth. At the time of the NCCF's Report, revolving credit at retailers far exceeded the amount on bank cards. Today, the positions are reversed. Numerous factors explain these trends, starting with convenience. Consumers who once carried cards for gas stations, department stores, travel companies, and specialty retailers have gradually lightened their load of plastic to a few favorites, commonly including a bank card that could substitute for the other accounts.

Consumers open about 6 million credit card accounts a month, and the vast majority of those originations by dollar volume come from consumers with good and better credit scores. According to CFPB data, subprime consumers (with scores below 620) originate less than a billion dollars of credit card debt a month, while near-prime consumers (620-659) open about $1.5 billion. Together they account for less than a 10 percent of the $30 billion that consumers rated at prime and above (660 and up) open up on new cards.[151]

Most of the products in this category can substitute for products in the other two. Consumers who qualify for any of the medium-term loans are likely to be sufficiently creditworthy to avail

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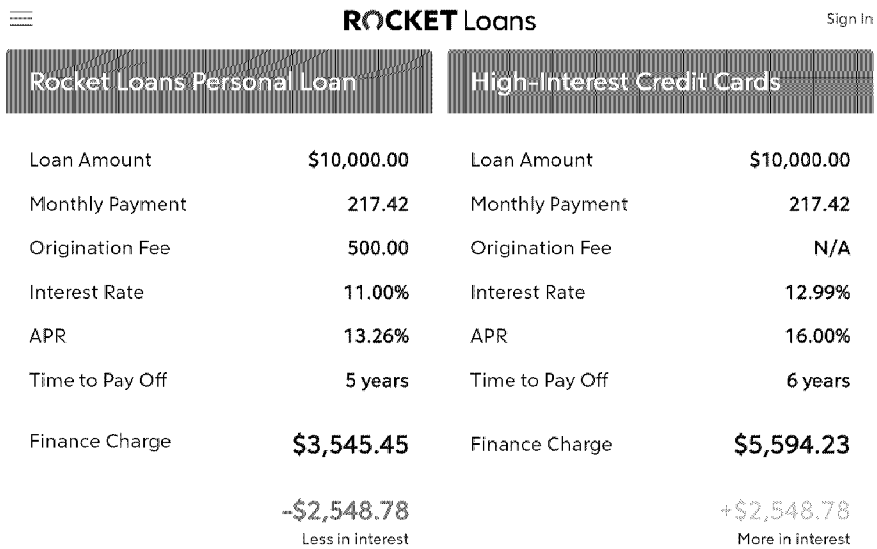
[150] *Payday Borrowers Are Far More Favorable Toward and Informed About Payday Loans than Voters without Payday Loan Experience*, PR NEWSWIRE, March 14, 2016, https://www.prnewswire.com/news-releases/new-survey--payday-borrowers-are-far-more-favorable-toward-and-informed-about-payday-loans-than-voters-without-payday-loan-experience-300235446.html

[151] CFPB, Borrower Risk Profiles, https://www.consumerfinance.gov/data-research/consumer-credit-trends/credit-cards/borrower-risk-profiles/.

themselves of any of the other medium-term or short-term options as well. Marketing makes it clear that banks and finance companies are competing across their sector boundary and offering consumers alternatives to credit card debt. Comparative advertising is often an indication of products that are likely substitutes for one another, and such advertising is plentiful. As an example, one of the top online lenders makes an appeal to cardholders that leaves little doubt that an installment loan is an alternative to credit card balances:[152]

FIGURE 8-12: ADD COMPARING PERSONAL LOAN AND CREDIT CARD



It is conceivable that a comparison of alternative sources of credit could determine that credit cards would not qualify as a market solely on the basis of consumer demand for loans. Nonetheless, because bank cards have gained such a large share of consumer credit, it is useful to consider the competition just among credit cards. Different cards offer a variety of interest rates and other terms. Cards from credit unions routinely offer better rates. The industry makes hundreds of millions of offers a year, enticing consumers to try new cards with lower fees, lower interest rates, more bonuses, and other attractive features. Merchants still take advantage of the opportunity at checkout to offer charge accounts. Consumers routinely acquire new cards to pay off more expensive debts. New credit cards have represented about a third of the 200,000 new

[152] Rocket Loan Home Page, https://www.rocketloans.com/ Accessed on September 3, 2020.

accounts opened in recent years.[153] Medium-term credit is a thriving marketplace with myriad options for consumers.

8.3.3 Installment Loans

The National Installment Lenders Association (NILA)stresses differences among installment, payday, and title loans—an indication of competition across the short-term and mid-term categories of credit:

These products are about as different as two products could be. [P]ayday companies do not test the ability to repay the loan from cash flow....Loans are typically of two weeks or one month's duration, and are payable in one lump sum....Data on these loans is not accepted by any major credit bureau. By contrast, traditional installment lenders do test the ability to repay, and the loans are payable in equal installments of principal and interest, giving the borrower a clear and manageable roadmap out of debt. Installment loans are reported to the credit bureaus, enabling responsible borrowers to build or repair their credit."[154]

Credit Karma's website search engine returns four companies with 11 options to an inquiry for a personal loan.[155] The APRs for a shopper (presumably anonymous and unscreened) ranged from 18 percent to more than 30 percent. Clicking a link for a lender allows one to apply for a loan. The ease of searching for loans, comparing offers, and securing funds with an online session, at rates approximating credit card rates, is an indication of competition, especially for those consumers with lower credit scores and in need of short-term cash. That installment loans attract multiple grades of borrowers and multiple sources of lenders suggests that they present alternatives for consumers considering many purposes. Characterized by one study as credit for the non-prime working classes, but better risks than payday borrowers, the business has grown dramatically. Non-prime borrowers owe an estimated $50 billion on installment loans,

[153] Credit card openings from CFPB, *see Consumer Credit Trends Credit Cards*, available at https://www.consumerfinance.gov/data-research/consumer-credit-trends/credit-cards/origination-activity/. All account openings from New York Fed (2020), *supra* note 130.

[154] National Installment Lenders Association, *Fundamentals,* available at https://nilaonline.org/fundamentals/ (internal notations deleted).

[155] Credit Karma, available at https://www.creditkarma.com/shop/personal-loans#newloans

borrowed from lenders that have avoided the public opprobrium and regulatory backlash that payday lenders have attracted.[156]

The actual interest rates that consumers pay will depend on whether they avail themselves of the benefits of competition. As is the case in any market, prices, terms, and conditions vary, and the variations can reflect competition, as consumers do not have identical preferences. Some consumers may be satisfied with their current lenders and prefer not to shop around, even though they might find themselves paying higher APRs than those who compare. Lending Tree, a company that facilitates loan shopping, surveyed personal loans available to borrowers with different credit scores. As replicated in Table 8-4, the difference between the minimum and maximum rates exceeded eight percentage points for borrowers in all categories – from subprime to excellent scores. On an average three-year loan of about $10,000, that difference translated into more than $1,600 in extra payments, even for the best credit risks.[157]

TABLE 8-4: SHOPPING AROUND FOR PERSONAL LOANS DIFFERENCE IN LOAN TERM OFFERS FOR THE AVERAGE 3-YEAR PERSONAL LOAN ($10,328) MAY 2018

Credit score range	Avg APR Offers Min	Avg APR Offers Max	Avg APR Offers Spread	Monthly Payments Min	Monthly Payments Max	Monthly Payments Spread	Total Payments Over 3 Years Min	Total Payments Over 3 Years Max	Total Payments Over 3 Years Spread
640 - 679	24.46%	33.01%	8.55%	$408	$456	$48	$14,678	$16,404	$1,726
680 - 719	17.19%	26.02%	8.83%	$369	$416	$47	$13,291	$14,984	$1,694
720 - 759	10.69%	19.97%	9.28%	$337	$384	$47	$12,118	$13,812	$1,695
760+	7.55%	16.38%	8.82%	$322	$365	$44	$11,575	$13,141	$1,566
All Borrowers	*18.51%*	*27.30%*	*8.79%*	*$376*	*$423*	*$47*	*$13,538*	*$15,239*	*$1,701*

156 Profile from Payments Journal, *The Ugly Side of Lending: Online Installment Loans* https://www.paymentsjournal.com/the-ugly-side-of-lending-online-installment-loans/

157 Kat Khoury , *LendingTree Study: Shopping Around for Personal Loans Can Save Consumers 35%,* (June 27, 2018). https://www.lendingtree.com/personal/lendingtree-study-shopping-around-for-personal-loans-can-save-consumers-35/.

Long-Term Products – Automobiles and Mortgages

Lending for automobile purchases was found competitive by the NCCF in 1970, and it appears to be so today. Auto loans may constitute a relevant market, given the maturities and securities involved. Car buyers may cross sector borders and borrow funds from other sources of secured loans (such as second-mortgage lenders), but unsecured loans are likely to be significantly more expensive than a loan backed by the security of a lien on the vehicle. Auto loans can come from banks, credit unions, thrifts, manufacturers, and the dealers themselves (although auto dealers typically act as middlemen for other institutions that provide credit).

Even though consumers with poor credit can find lenders willing to finance auto purchases, two-thirds of those loans are taken out by consumers with credit scores of 660 and above, the proportions have remained relatively constant in the past decade, as Figure 8-13 shows.[158]

FIGURE 8-13: AUTO LOAN ORIGINATIONS BY CREDIT SCORE

[158] New York Fed (2020), *supra* note 130.